Oregon

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March 20, 2007

OREGON PUBLIC UTILITY COMMISSION
ATTENTION: FILING CENTER
PO BOX: 2148
SALEM OR 97308-2148

RE: **Docket No. UM 1250** - In the Matter of AVISTA CORP. Application for an Order Approving a Corporate Reorganization to Create a Holding Company.

Enclosed for electronic filing in the above-captioned docket is the Public Utility Commission Staff's Direct Testimony.

/s/ Kay Barnes

Kay Barnes
Regulatory Operations Division
Filing on Behalf of Public Utility Commission Staff
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c: UM 1250 Service List (parties)

PUBLIC UTILITY COMMISSION OF OREGON

UM 1250

STAFF DIRECT TESTIMONY OF

Thomas D. Morgan

In the Matter of
AVISTA CORP.
Application for an Order Approving a Corporate Reorganization to Create a Holding Company.

<u>REDACTED VERSION</u>

March 20, 2007

CASE: UM 1250
WITNESS: Thomas D. Morgan

PUBLIC UTILITY COMMISSION
OF
OREGON

STAFF EXHIBIT 100

DIRECT TESTIMONY

REDACTED VERSION
March 20, 2007

CERTAIN INFORMATION CONTAINED IN STAFF EXHIBIT 100

IS CONFIDENTIAL AND SUBJECT TO PROTECTIVE

ORDER NO. 06-527. YOU MUST HAVE SIGNED

APPENDIX B OF THE PROTECTIVE ORDER IN

DOCKET UM 1250 TO RECEIVE THE

CONFIDENTIAL VERSION

OF THIS EXHIBIT.

1 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS**
2 **ADDRESS.**
3 A. My name is Thomas D. Morgan. My business address is 550 Capitol Street
4 NE Suite 215, Salem, Oregon 97301-2551.
5 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK**
6 **EXPERIENCE.**
7 A. My Witness Qualification Statement is found in Exhibit Staff/101.
8 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**
9 A. The purpose of my testimony is to respond to Avista Corporation's ("Avista
10 Corp" or "Company") request to reorganize into a holding company structure.
11 For reasons explained below, the Reorganization, as proposed by Avista
12 Corp, would not provide net benefits to ratepayers, primarily because it poses
13 too much risk to the financial health of the utility. However, staff has proposed
14 conditions that would require the Company to place additional focus on the
15 credit quality of the regulated utility. If these conditions are part of the
16 Reorganization, staff would conclude that the proposed Reorganization does
17 provide net benefits to customers, and would recommend that the Commission
18 approve Avista Corp's Application. However, if the Reorganization does not
19 include Staff's proposed conditions, or some variant that accomplishes the
20 same objectives, Staff recommends that the Commission deny Avista Corp's
21 Application.
22 **Q. DID YOU PREPARE EXHIBITS FOR THIS DOCKET?**

1 A. Yes. I prepared Exhibit Staff/102, 103 and 104. Exhibit 102 lists the conditions
2 that were initially proposed by Avista along with the recommended changes
3 proposed by Staff. Exhibit 103 includes reports referenced in this testimony
4 and Exhibit 104 provides two confidential financial statements that represent
5 the capitalization of the Company and one of its affiliates.

1 **THE COMPANY'S PLAN OF REORGANIZATION**

2 **Q. HOW DOES THE COMPANY PROPOSE TO REORGANIZE?**

3 A. Avista Corp proposes to modify its current corporate structure by adopting a
4 holding company organization (the "Reorganization"). Under the terms of the
5 Reorganization,[1] a holding company ("AVA" or "Parent Company") would be
6 the parent company of the regulated utility, "Avista Utilities." AVA would hold
7 Avista Utilities as a separate corporate entity along with a "sister" company,
8 Avista Capital, Inc. ("Avista Capital").

9 Because the Reorganization contemplates a change in the entity controlling
10 Avista's regulated operations, Avista Corp must obtain the Commission's
11 authorization under ORS 757.511

12 **Q. HOW WILL THE REORGANIZATION TAKE PLACE?**

13 A. Under the terms of the agreement, AVA would issue common stock shares
14 equal to the number of current outstanding shares of Avista Corp. Owners of
15 Avista Corp common stock would then exchange their Avista Corp shares for
16 shares of AVA. Any Avista Corp shareholder who "dissents" will receive
17 payment for their Avista Corp shares, rather than AVA shares. After the share
18 exchange is completed, AVA would own all of the shares of common stock of
19 Avista Utilities. The current holders of the common stock of Avista Corp will
20 hold all the common stock of AVA.

[1] The current and proposed corporate structures are available in Appendix A of the application, the "Comparison of Organization Structures". The terms of the share exchange, i.e., the holding company structure, are provided in the "Plan of Share Exchange," located at Appendix B of the Application and at UM 1250 Avista/202, Malquist/1. The plan has been adopted by Avista Corp's directors and shareholders.

1 **Q. HOW MANY SUBSIDIARIES OF THE PARENT COMPANY WOULD**
2 **THERE BE AFTER THE REORGANIZATION?**
3 A. Two. Avista Corp would cease to exist and AVA would become the new
4 Parent Company. Avista Utilities would become a subsidiary under the new
5 holding company, along with Avista Capital.
6 The Company represents that Avista Capital, a wholly-owned subsidiary of
7 Avista Corp, holds the Company's unregulated affiliate investments and that
8 the Reorganization would transfer Avista Capital to the Parent Company.
9 Avista Capital would continue to conduct business for approximately 17
10 companies that are currently organized under Avista Corp. Avista Capital
11 would remain as a business entity and would be directly held by the new
12 holding company.
13 **Q. DOES THE PLAN OF REORGANIZATION INCLUDE THE TRANSFER OF**
14 **ANY UTILITY ASSETS OR CHANGE IN REGULATORY JURISDICTION?**
15 A. No, Avista stated in its application that the Reorganization does not entail the
16 transfer of utility assets, that Avista customers would not see any change in the
17 utility or its operations, and that Avista Utilities would continue to be subject to
18 the existing regulatory jurisdiction Oregon Public Utility Commission on matters
19 impacting its Oregon customers such as rates and customer service.
20 **Q. WILL AVISTA UTILITIES HAVE ANY SUBSIDIARIES?**
21 A. Yes. Two entities that are currently held by Avista Corp, Spokane Energy LLC
22 and Avista Receivables, Inc., would be held by Avista Utilities. These
23 companies are "special purpose entities." Avista Receivables, Inc. "factors"

1 accounts receivables in order to provide cash flows prior to the actual collection
2 of amounts owed by customers. Spokane Energy, LLC was structured with
3 Enron and Portland General Electric (PGE), to "monetize" a long-term capacity
4 contract that existed between Avista Corp and PGE.
5 While the former company is consolidated on Avista's accounting records, the
6 latter organization is not.
7 **[CONFIDENTIAL/]**
8
9
10
11
12 **[/CONFIDENTIAL]**
13 **Q. WOULD OTHER SUBSIDIARIES INITIALLY REMAIN UNDER AVISTA**
14 **UTILITIES?**
15 A. Yes. Because of a loan covenant associated with a specific debt issuance, i.e.,
16 approximately $275 million of 9.75 percent Notes due in 2008, the Company
17 will not be able to complete the reorganization until the issuance is redeemed
18 or is liquidated. Without the approval of the debt holders, or prior to the
19 maturity date of the Notes (June 2008), all the subsidiaries would initially
20 remain under the umbrella of Avista Utilities. Until that time, the balance sheet
21 of Avista Capital would remain with the regulated company, Avista Utilities, and
22 there would be virtually no change in its capital structure.

1 However, upon the maturity of the 9.75% Notes, Avista Capital would be
2 "dividended" to the Holding Company (AVA).

3 **Q. WHY DOES THE COMPANY WANT TO REORGANIZE?**

4 A. The Company believes that the Reorganization would make it easier for the
5 Parent Company to enter into new businesses in order to diversify its
6 operations. It states that the Reorganization would allow the reorganized
7 structure to "better respond to the changing business environment of the
8 electric and natural gas industry, while providing the opportunity to further
9 insulate its utility business from its non-utility businesses." The Company
10 indicates that customers of its regulated operations would benefit by being
11 further insulated from the risks of the non-utility affiliates. (UM 1250/Exhibit
12 100, Norwood/2.)

13 **STANDARD OF REVIEW**

14 **Q. WHAT IS THE COMMISSION'S STANDARD OF REVIEW?**

15 A. The Commission applies a two-prong test to Applications under ORS 757.511.
16 The Commission examines whether the utility's customers "will be served" by
17 the proposed transaction and whether the transaction is in the public interest.
18 To answer the first question, the Commission determines whether customers
19 will realize a "net benefit" from the proposed transaction. To answer the
20 second, the Commission determines whether the proposed transaction will
21 impose a detriment to Oregon citizens as a whole. (OPUC Order No. 01-778
22 at 11.)

STAFF ANALYSIS

Q. DOES THE COMPANY'S APPLICATION SATISFY THE COMMISSION'S ORS 757.511 CRITERIA?

A. No. Staff agrees with the Company that the proposed Reorganization could benefit customers by further insulating them from the Company's unregulated activities. However, the Reorganization also poses risks. Avista Corp's financial rating is currently below investment grade. Similarly, Avista Corp's equity level, and the anticipated equity level for Avista Utilities, are below what at least one ratings agency (Standard & Poor's) has determined is the minimum level for investment grade. The conditions that Avista Corp offers in its Application do not sufficiently mitigate risk associated with the expected financial condition and capital structure of Avista Utilities and AVA.

Q. PLEASE EXPLAIN.

A. As of the end of 2006, Avista Corp had a consolidated 45.17 percent level of equity and a secured-debt credit rating of BB+, which is non-investment grade. This credit rating is at least three notches below the credit ratings of all other Oregon utilities regulated by the Commission, which are all investment grade. If the reorganization were completed immediately, Avista Utilities would have about a 37.5 percent equity level. This capitalization does not include a significant amount of "off balance sheet" leverage. See Staff/104, Morgan/2.

The independent credit rating of the reorganized Avista Utilities Company has not been determined, and it is likely to be no greater than AVA's anticipated

1 rating, due to its weaker financial structure. These low levels of equity and
2 relatively low credit ratings pose risks to customers of Avista Corp's regulated
3 operations. Most notably, given its relatively low level of equity, the Parent
4 Company could further erode the financial strength of the utility by draining
5 equity in order to provide a dividend to its ratepayers.

6 Furthermore, Avista Corp's plans for the long-term debt that it currently holds
7 pose some risk to customers. All of the debt currently held by Avista Corp
8 would remain with Avista Utilities, including secured First Mortgage Bonds
9 (FMBs), unsecured debt and preferred stock, and all other agreements to
10 which the Company is a party, would remain with Avista Utilities. (*See*
11 paragraph 24 of the Application, page 8.)

12 Prior to the formation of the holding company, the regulated utility capital
13 structure was viewed from a consolidated basis. The company proposes
14 the formation of a holding company whereby about $250 million of equity
15 value is transferred away from the regulated utility to the affiliated sister
16 company, Avista Capital. In addition, virtually of the existing debt capital
17 ($1.1 billion) would remain with the regulated utility.

18 **Q. HOW WOULD THIS AFFECT AVISTA UTILITIES?**

19 A. All else being equal, removing a quarter billion dollars in equity from the
20 utility company and saddling it with all the existing debt obligations, makes
21 the utility riskier than if the Reorganization did not take place. Because the
22 debt requirements will be shifted almost entirely onto the regulated utility,

1 additional risk is evident if the utility company is being depended upon to
2 also fund the dividend requirements of the company. This financial risk is
3 the primary negative aspect to the proposed reorganization.

4 **Q. DOES AVISTA CORP PROPOSE RING FENCING PROVISIONS TO**
5 **ADDRESS RISK POSED BY THE REORGANIZATION?**

6 A. Yes and several are satisfactory. However, as a whole, they are not sufficient
7 to protect ratepayers from the risks associated with the Reorganization. The
8 most notably deficient ring fencing provisions are Avista Corp's commitments
9 concerning the equity level of Avista Utilities. Avista Corp commits that it will
10 increase its equity level to 35% by December 31, 2007, and to 38% by
11 December 31, 2008, and that it will not make any dividends to AVA that will
12 reduce Avista Utilities' common equity capital below 25%. If Avista Corp does
13 not meet the equity level benchmarks, Avista Corp proposes automatic 2%
14 decreases to Avista's base rates. Specifically, if Avista Utilities does not meet
15 the 2007 benchmark, its rates would decrease by 2% on April 1, 2008. If
16 Avista Utilities does not meet the 2008 benchmark, its rates would decrease by
17 2% on April 1, 2009.

18 **Q. WHY ARE THESE PROVISIONS DEFICIENT?**

19 A. These ring fencing provisions do little to facilitate the goal of increasing Avista
20 Utilities' equity level and financial strength. The penalties that Avista Corp
21 proposes may in fact be counterproductive, because the penalties will reduce
22 Avista Utilities' revenues and possibly negatively impact its credit ratings. If the
23 penalty provisions are triggered, it will not only mean that Avista Utilities has

1 failed to increase its equity level, but may mean that its ability to do so on a
2 going forward basis is impaired because its revenues are reduced.
3 Furthermore, Avista Corp's commitment that Avista Utilities will not make a
4 dividend to AVA if Avista Utilities equity level is below 25 percent is of
5 negligible value. In order to be a useful protection for ratepayers, the equity
6 level floor must be a good deal higher before dividends should be available.
7 **Q. WHAT CONDITIONS DOES STAFF PROPOSE TO BETTER PROTECT**
8 **RATEPAYERS FROM RISKS ASSOCIATED WITH THE**
9 **REORGANIZATION?**
10 A. First, staff removes the condition reducing Avista Utilities rates if its equity level
11 targets are not met. Second, staff strengthens Avista Corp's condition
12 prohibiting it from providing dividends to AVA if its total equity ratio is below 25
13 percent. Specifically, staff increases the equity ratio floor from 25 percent to 33
14 percent in 2007, 38 percent in 2008, 40 percent in 2009, and 44 percent
15 thereafter. Staff also proposes a condition that would allow Avista Utilities to
16 make a dividend to AVA only if Avista Utilities' interest coverage is greater than
17 2.5:1, and still would be after the dividend or, if its senior unsecured long-term
18 debt rating is at or better than BBB with Standard & Poor's or Baa2 with
19 Moody's Investor Service, Inc.
20 **Q. WHY ARE THESE CONDITIONS SUPERIOR TO THOSE PROPOSED BY**
21 **AVISTA CORP?**
22 A. The conditions proposed by Avista Corp merely exacerbate the risk proposed
23 by the Reorganization. This is because the conditions only increase the risk to

1 Avista Utilities' financial health by creating financial penalties if Avista Utilities
2 does not meet certain benchmarks, while at the same time, providing no clear
3 path to meeting those benchmarks.
4 In contrast, staff's proposed conditions address this risk, rather than
5 exacerbate it, and provide Avista Utilities realistic tools to improve its capital
6 structure and financial health. Staff increased the minimum equity ratio for
7 providing dividends to AVA in order to give cushion in which to increase equity
8 free from pressure to provide dividends to AVA. Secondly, staff added a
9 condition ensuring that it will only provide a dividend to AVA Corp when it can
10 demonstrate a satisfactory interest coverage rate or senior unsecured long-
11 term debt rating. Finally, staff increased the benchmark equity ratios to help
12 ensure Avista Utilities financial condition and ratings improve.

13 **Q. DO PRIOR COMMISSION ORDERS SUPPORT THE RING FENCING**
14 **PROVISIONS PROPOSED BY STAFF?**

15 A. Yes. In Docket No. UM 1209, in which the Commission addressed
16 MidAmerican Energy Holding Company's ("MEHC") application to acquire
17 PacifiCorp, parties to the docket, including staff and the Citizens' Utility Board
18 ("CUB"), identified risks in the transaction proposed by MEHC that are similar
19 to those presented by Avista Corp's Application. In that case, staff was
20 concerned that MEHC's short-term financial obligations would cause MEHC to
21 put pressure on PacifiCorp to produce funds to meet those obligations. Staff
22 was also concerned that MEHC's debt would negatively impact PacifiCorp's
23 credit rating and therefore increase PacifiCorp's cost of debt. In response to

1 these concerns, MEHC agreed to several ring-fencing provisions to insulate
2 MEHC from PacifiCorp, including MEHC's agreement that the equity level in
3 the consolidated capital structure of PPW Holdings LLC would be no less than
4 agreed-to minimums, initially 48.25 percent and declining to 44 percent over
5 several years. MEHC also agreed that no dividends would be taken from
6 PacifiCorp if PacifICorp's unsecured debt is rated BBB- or lower by Standard &
7 Poor's or Fitch, or Baa3 or lower by Moody's. Order No. 06-082 at 15-16. The
8 Commission concluded that these ring fencing provisions mitigated concerns
9 raised by parties in that docket that are similar to those raised by staff and
10 were sufficient to protect PacifiCorp from financial degradation and ratepayers
11 from any ill effects arising from a ratings downgrade attributable to the
12 transaction. (Order No. 06-082 at pp 7-8.)
13 PGE agreed to similar conditions in connection with its recent request to re-
14 distribute its stock to Enron's creditors in 2006. PGE agreed that it would not
15 pay a dividend to shareholders if it would cause its common equity capital to
16 fall below 48 percent. Order No. 05-1250. The condition agreed to in that
17 docket provided that the ratio would change as the ownership of PGE by the
18 bankrupt Enron estate reduced its holdings of PGE's stock.
19 In response to similar concerns raised during its bid to purchase PGE in
20 1996-97, Enron agreed that PGE would maintain a minimum level of 48
21 percent equity. OPUC Order No. 97-196. Scottish Power made the same
22 commitment regarding PacifiCorp when it purchased PacifiCorp in 1999.
23 OPUC Order No. 99-616.

1 **Q. IS THERE EVIDENCE FROM CREDIT RATING AGENCIES OR OTHER**
2 **ORGANIZATIONS THAT SUPPORT STAFF'S PROPOSAL?**
3 A. Yes. I will discuss two sources that support Staff's position.
4 The first is a Standard & Poor's presentation at the American Gas Association
5 Financial Forum, on May 7, 2006, titled "Understanding the Ratings Process."
6 See Staff/103.[2]
7 S&P indicates that insulation factors include regulatory requirements, such as
8 the limitation on upstream dividends and mandated leverage and coverage
9 tests. S&P promotes structural separation ring-fencing measures, which
10 include not only legal separation, but also economic disincentives that would
11 support the regulated enterprise. (*See* Slide 5 of 25)
12 Staff's proposed conditions would provide meaningful support for the
13 proposed Reorganization, and are consistent with the expectations of S&P.
14 S&P indicates that the "regulatory safety net is important to protect a utility.
15
16 Healthy Regulated Company (*See* Slide 8)
17 - Reliable regulatory decisions adjudicated in a timely manner
18 - Solid and predictable cash flow generation
19 - Ready access to capital markets
20 - Steady, straightforward business strategy
21 - Transparent balance sheet
22 - Effective liability and liquidity management

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[2] http://www.aga.org/Content/ContentGroups/Investor_Relations1/Presentations1/S&PFF06.ppt

1
2 Liability Management (See Slide 20)
3 - Important indicator of credit quality
4 - Issuers approach to liability management has a direct
5 correlation with level of embedded risk
6 - Vulnerability to refinancing risk
7 - Debt duration and maturity profile
8 - Contingent liabilities & off-balance sheet obligations
9
10 The other source of information supporting staff's proposed ring-fencing
11 conditions is found in a report entitled, "Can 'Ring-Fencing Protect Ratepayers
12 from Risk"? Richard Stavros, an author for Public Utilities Fortnightly, quotes
13 "Can 'Ring-Fencing' Protect Ratepayers from Risk,"[3] which states:

14 "Fitch Ratings, in a meeting with state regulators last year, said there is no
15 perfect ring-fence that can completely insulate a utility. According to Fitch,
16 companies have an inalienable right to force a subsidiary into bankruptcy. A
17 company cannot waive this right, according to the general counsel at Fitch.
18 The National Association of Regulatory Utility Commissioners' (NARUC)
19 subcommittee on Accounting and Finance last year investigated the issue of
20 ring-fencing in an attempt to identify best practices….
21
22 Therefore, no matter how stringent a Commission's authority may be, without
23 solid preventative measures, the credit quality of a regulated utility may cause
24 it to be drawn into bankruptcy proceedings, or to otherwise suffer ill effects of a
25 transaction or reorganization. Strong ring fencing measures provided

[3] Stavros, Richard, "Taking Business Private: Return of the Barbarians," *Public Utilities Fortnightly*, February 2004, pp. 25-29

1 significant support to Portland General Electric (PGE) during the bankruptcy of
2 Enron. Staff's proposed conditions are designed to support the regulated
3 operation of Avista Utilities.

4 **Q. ARE THERE OTHER ORGANIZATIONS THAT SUPPORT STAFF'S**
5 **PROPOSAL?**

6 A. Yes. A subcommittee from the National Association of Regulatory Utility
7 Commissions (NARUC) suggests several ring-fencing measures to protect
8 regulated utilities from their parent companies. The following provides
9 NARUC's recommendations regarding reasonable ring fencing proposals:

10 - Commission authority to restrict and mandate use and terms of sale
11 of utility assets. This includes restriction against using utility assets
12 as collateral of guarantee for any non-utility business.
13
14 - Commission authority to restrict dividend payments to a parent
15 company in order to maintain financial viability of the utility. This
16 may include, but is not limited to maintenance of a minimum equity
17 ratio balance.
18
19 - Commission authority to authorize loans, loan guarantees,
20 engagement in money pools and large supply contract between
21 utility and affiliate companies.
22
23 - Commission authority over the establishment of a holding company
24 structure involving a regulated utility.
25
26 - Expand commission authority over security applications to include
27 the ability to restrict type and use of financing.

1 **Q. DOES STAFF PROPOSE ADDITIONAL MODIFICATIONS TO THE**
2 **CONDITIONS PROPOSED BY AVISTA CORP?**
3 A. Yes. Staff started with the conditions proposed by Avista Corp in the testimony
4 of Avista Corp witness Kelly Norwood. The conditions that Avista Corp offers
5 in this case are conditions to which Avista Corp and the staff of the Idaho
6 Public Utility Commission stipulated in connection with Avista Corp's
7 application to reorganize filed in that state (hereinafter referred to as "the Idaho
8 Conditions"). The Idaho Public Utilities Commission approved the stipulation
9 and has allowed Avista Corp's application.
10 As already noted, staff found 14 of the conditions satisfactory. However,
11 staff's proposed conditions omit a few of the Idaho Conditions that are not
12 necessary, e.g., relating to the authority of the Idaho Public Utilities
13 Commission or authority the Oregon Commission has by statute, modify
14 others, and include conditions not found in the Idaho Conditions.
15 **Q. WHAT ADDITIONAL CONDITIONS DOES STAFF PROPOSE?**
16 A. In addition to the two conditions I discuss above relating to Avista Utilities
17 ability to issue dividends to AVA, staff proposes conditions providing that:
18 - Avista Utilities will not voluntarily enter into bankruptcy without first
19 obtaining a Commission order that doing so will benefit customers;
20 - AVA and Avista Utilities will not contest any motion asserting, or order or
21 judgment stating, that the Commission retains its full authority over
22 Avista Utilities in the event of either voluntary or involuntary bankruptcy
23 affecting either AVA or Avista Utilities;

- AVA or an AVA subsidiary may not convey a subsidiary to Avista Utilities without Commission approval.
- AVA, Avista Utilities and all subsidiaries of each will separately account for their respective assets and liabilities.
- Before December 31, 2009, neither Avista Utilities nor any of its other subsidiaries will enter into any electric or natural gas commodity transactions, either physical or financial with AVA or its other affiliates or subsidiaries.

Staff also recommends that the Commission adopt the same provisions it has adopted in previous ORS 757.511 proceedings that establish the mechanism by which the Commission may impose penalties if any of the conditions are violated and a dispute resolution mechanism AVA, Avista Utilities and staff will use to resolve any disputes regarding inspection or discovery of AVA's books and records.

Q. PLEASE DISCUSS STAFF'S CONDITIONS RELATING TO BANKRUPTCY.

A. Staff proposes that any voluntary bankruptcy filing that includes Avista Utilities or any of its subsidiaries should be in the best interest of customers, and that such a showing should be provided prior to entering into bankruptcy.

Q. PLEASE DISCUSS STAFF'S CONDITION REQUIRING AVISTA UTILITIES, AVA AND ALL SUBSIDIARIES OF BOTH TO SEPARATELY ACCOUNT FOR THEIR ASSETS AND LIABILITIES.

A. This condition buttresses a condition proposed by Avista Corp that requires AVA, Avista Utilities, and all subsidiaries to maintain separate books and

1 records. Providing that Avista Utilities, AVA, and all subsidiaries actually
2 account for their assets separately provides an additional level of assurance
3 that Avista Corp's other affiliates will also maintain segregated and
4 independent accounting.
5 **Q. PLEASE DISCUSS STAFF'S CONDITION PROHIBITING AVISTA UTILITIES**
6 **FROM ENTERING INTO NATURAL GAS COMMODITY TRANSACTIONS**
7 **WITH AVA OR ITS SUBSIDIARIES.**
8 A. This condition was considered in other states for the review of the Company's
9 reorganization. While it may not be necessary for inclusion in Oregon due to
10 existing affiliated interest statutes and associated rules and policies, it clarifies
11 Staff's expectations.
12 **Q. PLEASE DISCUSS STAFF'S CONDITION PROHIBITING AVA OR ITS**
13 **SUBSIDIARIES FROM CONVEYING A SUBSIDIARY TO AVISTA UTILITIES.**
14 A. This condition is to guarantee that no assets other than those that support the
15 regulated operations of Avista Utilities is maintained under the utility's
16 corporate structure and is partially to assure that there is no potential cross
17 subsidization.
18 **Q. PLEASE DISCUSS STAFF'S CONDITIONS REGARDING THE MECHANISM**
19 **FOR IMPOSING PENALTIES AND DISPUTE RESOLUTION FOR**
20 **DISCOVERY.**
21 A. Staff replaced the penalty mechanism posed by Avista Utilities because Avista
22 Corp's condition does not provide substantial relief in the event of violations of
23 accepted conditions. Under the condition proposed by Avista Utilities, the

1 Commission would issue a written notification of violation and Avista would
2 have five to ten days to correct the satisfy the condition, including report filing,
3 or the Company could request extensions. If the violations are not addressed,
4 then the Commission would have to determine the appropriate penalty. Staff's
5 version of the condition allows a similar ten-day period for response by the
6 Company. However, if there is no response, or if the response is not timely,
7 then Staff's proposal provides a specific course of action that could be taken.

8 **Q. WHICH OF THE IDAHO CONDITIONS DOES STAFF OMIT?**

9 A. Staff omits six of the Idaho Conditions. A brief description of each condition,
10 and the reasons for omission, are below:

11 - *Idaho Condition 14: Provides that the capital requirements of Avista*
12 *Utilities would be given high priority by the Boards of Directors of AVA*
13 *and Avista Utilities.* Staff omitted this condition because the obligation
14 to serve the customers of the utility includes providing capital for
15 necessary projects.
16 - *Idaho Condition 15: Provides certain limitations on Affiliated Interest*
17 *transactions and loan guarantees.* Staff omitted this condition because
18 it is not needed: the Commission has existing statutory authority to
19 approve inter-company agreements and to limit financial support of non-
20 regulated affiliates by the regulated entity.
21 - *Idaho Condition 17: Provides that Avista Utilities will be subject to an*
22 *automatic rate reduction if it does not meet a benchmark equity ratio in*
23 *2007 and 2008. For the reasons discussed above, staff omitted this*

condition and replaced it with an equity building provision that is similar to conditions agreed to by parties and approved by this Commission in previous ORS 757.511 proceedings.

- *Idaho Condition 18: Provides that Avista Utilities would not send dividends if the result would cause the total equity capital of the utility to fall below 25 percent. For the reasons discussed above, staff omitted this condition and replaced it with minimum interest coverage and credit rating criteria.*
- *Idaho Condition 22: Provides that Avista Utilities must apply with the Idaho Commission for approval of security issuances under Idaho law.* Staff omitted this condition because it is not needed: the Commission has existing statutory authority to approve the issuance of securities.
- *Condition 32: Describes a mechanism parties are encouraged to use to address violations of the Idaho Conditions.* Staff replaced this provision with a comparable condition that has been agreed to and approved in several Oregon ORS 757.511 proceedings.

Q. WHICH OF THE IDAHO CONDITIONS DID STAFF MODIFY?

A. Staff modified 12 of the proposed Idaho Conditions, including Numbers 1, 2, 6, 9, 12, 13, 20, 21, 23, 24, 25 and 29.

For the most part, the re-wording addresses minor changes.

- *Condition 1*: As discussed previously, Staff's proposed changes to *Condition 1* provide for a better level of accounting control among AVA and its affiliates. Avista Corp agreed to a similar modification in

1 Washington. The Idaho Conditions that Avista Corp has proposed in
2 this docket include a "most-favored nation" clause, which means that
3 under Avista's proposal, the Oregon Commission is free to adopt any
4 of the conditions adopted in Avista's other jurisdictions. Presumably,
5 therefore, Staff's proposed modification to Condition 1 should be
6 acceptable to Avista Corp.

7 • *Condition 2:* Staff slightly modified Condition 2 concerning the
8 Commission's access to the books and records of Avista Utilities, AVA,
9 and their subsidiaries and affiliates so that it compares to the discovery
10 standard in Oregon's Rules of Civil Procedure. In Oregon, parties in
11 civil matters are allowed to "discover" information that is reasonably
12 calculated to lead to the discovery of admissible information. Staff has
13 modified Condition 2 to allow the Commission to seek information from
14 AVA and its subsidiaries and affiliates, as well as from the subsidiaries
15 and affiliates of Avista Utilities, that is either relevant to the business of
16 Avista Utilities or may lead to information that is relevant to the
17 business of Avista Utilities.

18 • *Condition 6: Staff made* a minor change to clarify where Avista Utilities
19 files the document required under Avista Corp's proposed condition
20 six.

21 • *Condition 9*: Staff removed the portion of Avista's proposed condition
22 that relates to the transfer pricing policy because it is already a part of
23 the Commission's policies and practices.

- *Condition 12*: Staff added additional language to limit the inclusion of costs "associated with" as well as "of" the formation of the holding company in the utility's regulated accounts.
- *Condition 13:* Staff included language like that described in Condition 6.
- *Condition 20*: Staff included a requirement of written notification in the event of a credit rating downgrade, which supplement's Avista's proposal of scheduling a meeting with Commission Staff.
- *Condition 21: Staff* expounded on the requirement for annual filings that pertains to compliance with these conditions.
- *Conditions 23 and 24:* Staff addressed how certain information would be provided for Staff's review, upon request.
- *Condition 25*: Staff removed some of the notification obligations proposed by the Company.
- *Condition 29*: Staff clarified the meaning of the phrase "less than" in the condition.

Q. SHOULD THE COMMISSION ALLOW AVISTA CORP'S APPLICATION WITHOUT THE CONDITIONS AS PROPOSED BY STAFF?

A. No. Staff proposes ring-fencing conditions that, when combined with other conditions proposed by Avista Corp, sufficiently protect the Company's regulated operations for purposes of the Commission's analysis. Meaning, with the additional and modified conditions proposed by staff, the Reorganization will provide net benefits to Avista Corp's Oregon ratepayers.

1 **Q. WHAT IF AVISTA CORP DOES NOT AGREE TO STAFF'S CONDITIONS OR**
2 **REASONABLE ALTERNATIVES?**
3 A. In that case, staff recommends that the Commission either reject the
4 Application or approve the Application subject to the conditions as proposed by
5 staff.
6 **Q. DOES THE COMMISSION HAVE STATUTORY AUTHORITY TO APPROVE**
7 **THE APPLICATION SUBJECT TO CONDITIONS?**
8 A. The Commission discussed that question in Docket No. UM 1121. As already
9 noted, that docket concerned TPG's application for authority to acquire PGE.
10 Several parties opposed the proposed transaction, and recommended that the
11 Commission allow TPG's application only if the Commission imposed certain
12 conditions. The Commission noted that there is some ambiguity as to whether
13 the Commission has authority to approve an application under ORS 757.511
14 subject to conditions. However, the Commission did not resolve that question,
15 instead deciding that as a matter of discretion, it would not do so in that case.
16 Order No. 05-114 at 19.
17 The resolution of the issue regarding the Commission's authority under ORS
18 757.511 is beyond the scope of this testimony and should be addressed in
19 briefs, if necessary. In any event, Staff recommends that if Avista Corp
20 declines to agree to the conditions recommended by staff, and if the
21 Commission decides that it does not have authority to identify conditions under
22 which it would approve the Application, the Commission should deny Avista
23 Corp's Application. If the Commission concludes it does have authority to

1 approve an ORS 757.511 Application subject to conditions, staff recommends
2 that the Commission approve Avista Corp's Application, subject to the
3 conditions as staff recommends them.

4 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

5 A. Yes.

CASE: UM 1250
WITNESS: Thomas D. Morgan

PUBLIC UTILITY COMMISSION OF OREGON

STAFF EXHIBIT 101

Witness Qualification Statement

March 20, 2007

WITNESS QUALIFICATIONS STATEMENT

NAME:	Thomas D. Morgan
EMPLOYER:	Public Utility Commission of Oregon
TITLE:	Senior Financial Economist, Economic & Policy Analysis
ADDRESS:	550 Capitol St NE Suite 215, Salem, Oregon 97301-2551.
EDUCATION:	Bachelor of Science in Business Administration, Finance; 1993, University of Oregon, Eugene, Oregon *summa cum laude*. I am enrolled in Master of Science in Finance program through the University of Leicester (UK).

RELEVANT WORK EXPERIENCE:

Since August 2001, I have been employed by the Public Utility Commission of Oregon as a financial analyst in the Economic Research & Financial/Policy Analysis Division. Current responsibilities include conducting research and providing technical support for cost of equity issues for electric, telecommunications, and gas utilities.

From October 1997 to August 2001, I worked for the Oregon Department of Revenue as a Senior Appraiser Analyst in the Utility Program, Valuation Section of the Property Tax Division. Duties included appraising a variety of public utility and transportation properties. The valuation process included developing cost of capital studies for use in the discounting of cash flows in the Income Capitalization Approach to value. Duties included valuation of the property owned by gas, electric, telecommunication and airline companies.

I am a certified general property appraiser and have been involved in the valuation of commercial properties since 1993.

CASE: UM 1250
WITNESS: Thomas D. Morgan

PUBLIC UTILITY COMMISSION
OF
OREGON

STAFF EXHIBIT 102

Exhibits in Support
of Direct Testimony

March 20, 2007

STAFF'S REVIEW OF AVISTA'S PROPOSED REORGANIZATION CONDITIONS

Note: Highlighted Staff Conditions reflect to proposed changes to Avista's proposal.

Avista-proposed Conditions Pursuant to the Idaho PUC Stipulation:

1.) Avista Utilities will maintain its own books and records, separate from AVA's books and records. Avista Utilities' financial books and records and state and federal utility regulatory filings and documents will continue to be available to the Commission, upon request.

STAFF PROPOSED CONDITION: 1.) Avista Utilities (hereinafter "Avista Utilities") will maintain its own books and records, separate from ~~AVA's~~ the books and records of AVA Formation Corp. (hereinafter "AVA"). The assets of Avista Utilities and AVA and their subsidiaries or affiliates will be separately accounted for. Avista Utilities' financial books and records and state and federal utility regulatory filings and documents will continue to be available to the Commission, upon request.

2.) AVA and Avista Utilities will provide the Commission access to all books of account as well as all documents, data, and records of their affiliated interests, which pertain to transactions between Avista Utilities and its affiliated interests or which are otherwise relevant to the business of Avista Utilities.

STAFF PROPOSED CONDITION: 2.) AVA and Avista Utilities will provide the Commission and other parties to this Docket upon request, access to all books of account as well as all documents, data, and records of their affiliated interests, which pertain to transactions between Avista Utilities and its affiliated interests or which ~~are otherwise~~may lead to relevant ~~to~~information regarding the business of Avista Utilities.

3.) AVA, Avista Utilities and all affiliates will make their employees, officers, directors and agents available to testify before the Commission to provide information relevant to matters within the jurisdiction of the Commission.

STAFF PROPOSED CONDITION: 3.) AVA, Avista Utilities and all affiliates will make their employees, officers, directors and agents available to testify before the Commission to provide information relevant to matters within the jurisdiction of the Commission.

4.) AVA and Avista Utilities agree that one of its independent directors on each Board of Directors will have had prior experience with respect to the operation, financial analysis or regulation of the regulated gas or electric utility industry.

STAFF PROPOSED CONDITION: 4.) AVA and Avista Utilities agree that one of its independent directors on each Board of Directors will have had prior experience with respect to the operation, financial analysis or regulation of the regulated gas or electric utility industry.

5.) The Commission or its agents may audit the accounting records of AVA and its subsidiaries that are the bases for charges to Avista Utilities, to determine the reasonableness of allocation factors used by AVA to assign costs to Avista Utilities and amounts subject to allocation or direct charges. AVA agrees to cooperate fully with such Commission audits.

STAFF PROPOSED CONDITION: 5.) The Commission or its agents may audit the accounting records of AVA and its subsidiaries that are the bases for charges to Avista Utilities, to determine the reasonableness of allocation factors used by AVA to assign costs to Avista Utilities and amounts subject to allocation or direct charges. AVA agrees to cooperate fully with such Commission audits.

6.) Avista Utilities will file on an annual basis a copy of any affiliated interest report filed in other jurisdictions.

STAFF PROPOSED CONDITION: 6.) Avista Utilities will file with the Commission, on an annual basis, a copy of any affiliated interest report(s) filed in other jurisdictions.

7.) AVA and Avista Utilities will comply with all applicable Commission statutes and regulations regarding affiliated interest transactions, including timely filing of applications and reports.

STAFF PROPOSED CONDITION: 7.) AVA and Avista Utilities will comply with all applicable Commission statutes and regulations regarding affiliated interest transactions, including timely filing of applications and reports.

8.) Avista Utilities and AVA will not cross-subsidize between the regulated and non-regulated businesses or between any regulated businesses, and shall comply with the Commission's applicable orders and rules with respect to such matters.

STAFF PROPOSED CONDITION: 8.) Avista Utilities and AVA will not cross-subsidize between the regulated and non-regulated businesses or between any regulated businesses, and shall comply with the Commission's applicable orders and rules with respect to such matters.

9.) Any proposed cost allocation methodology for the allocation of corporate and affiliate investments, expenses, and overheads, required by law or rule to be submitted to the Commission for approval, will comply with the following principles:

STAFF PROPOSED CONDITION: 9.) Any proposed cost allocation methodology for the allocation of corporate and affiliate investments, expenses, and overheads, required by law or rule to be submitted to the Commission for approval, will comply with the following principles:

a. For services rendered to Avista Utilities or each cost category subject to allocation to Avista Utilities by AVA or any of

b. Cost allocations to Avista Utilities and its subsidiaries will be based on generally accepted accounting standards; that is,

c. AVA and its subsidiaries will have in place accounting systems adequate to support the allocation and assignment of
d. An audit trail will be maintained such that all costs subject to allocation can be specifically identified, particularly with
e. Costs which would have been denied recovery in rates had they been incurred by Avista Utilities regulated operations
f. Any corporate cost allocation methodology used for rate setting, and subsequent changes thereto, will be submitted to
g. AVA and Avista Utilities commit to use asymmetrical pricing (i.e., lower of cost or market for transactions to Avista

STAFF COMMENT: Subitem g. is excluded from Staff's proposal.

10.) Avista Utilities will maintain separate debt and, if outstanding, preferred stock ratings. Avista Utilities will maintain its own corporate credit rating, as well as ratings for each long-term debt and preferred stock (if any) issuance.

STAFF PROPOSED CONDITION: 10.) Avista Utilities will maintain separate debt and, if outstanding, preferred stock ratings. Avista Utilities will maintain its own corporate credit rating, as well as ratings for each long-term debt and preferred stock (if any) issuance.

11.) Within three months of closing of the transaction, AVA and Avista Utilities commit to obtain from one or more rating agencies written confirmation that Avista Utilities will have its own corporate credit rating, separate and apart from AVA, as well as separate ratings for each long-term debt and preferred stock (if any) issuance, and that it will not otherwise be consolidated with AVA for ratings purposes. If the ring-fencing provisions of this stipulation are insufficient for purposes of obtaining a separate rating for Avista Utilities, AVA and Avista Utilities will so notify the Commission and propose and implement, upon Commission approval, such additional ring-fencing provisions that are sufficient to secure separate corporate ratings for AVA and Avista Utilities.

STAFF PROPOSED CONDITION: 11.) Within three months of closing of the transaction, AVA and Avista Utilities commit to obtain from one or more rating agencies written confirmation that Avista Utilities will have its own corporate credit rating, separate and apart from AVA, as well as separate ratings for each long-term debt and preferred stock (if any) issuance, and that it will not otherwise be consolidated with AVA for ratings purposes. If the ring-fencing provisions of this stipulation are insufficient for purposes of obtaining a separate rating for Avista Utilities, AVA and Avista Utilities will so notify the Commission and propose and implement, upon Commission approval, such additional ring-fencing provisions that are sufficient to secure separate corporate ratings for AVA and Avista Utilities.

12.) AVA and Avista Utilities will exclude all costs of the formation of the Holding Company from Avista Utilities' utility accounts.

STAFF PROPOSED CONDITION: 12.) AVA and Avista Utilities will exclude all costs ~~of~~ associated with the formation of the Holding Company from Avista Utilities' utility accounts.

13.) AVA and Avista Utilities will provide the Commission with unrestricted access to all written information provided by and to credit rating agencies that pertains to Avista Utilities or AVA. AVA will also provide the Commission with unrestricted access to all written information provided by and to credit rating agencies that pertains to AVA's subsidiaries to the extent such information may potentially impact Avista Utilities.

STAFF PROPOSED CONDITION: 13.) AVA and Avista Utilities will provide the Commission and other parties to this Docket upon request, with unrestricted access to all written information provided ~~by and~~ to credit rating agencies by or for AVA or Avista Utilities that pertains to Avista Utilities or AVA. AVA and Avista Utilities will provide the Commission and other parties to this Docket upon request, with unrestricted access to all written information provided to AVA or Avista Utilities by the credit rating agencies. AVA will also provide the Commission, and other parties to this Docket upon request, with unrestricted access to all written information provided by and to credit rating agencies that pertains to AVA's subsidiaries to the extent such information may potentially ~~impact~~ lead to information regarding Avista Utilities.

14.) The capital requirements of Avista Utilities, as determined to be necessary to meet its obligation to serve the public, will be given a high priority by the Board of Directors of AVA and Avista Utilities.

STAFF PROPOSED CONDITION: 14.) REMOVED ORIGINAL AND REPLACED THE FOLLOWING: Avista Utilities and AVA will not advocate for a higher cost of capital as compared to what Avista Utilities' cost of capital would have been, absent the reorganization.

15.) Neither Avista Utilities nor its subsidiaries will, on a prospective basis, without prior notification to the Commission, make loans or transfer funds (other than dividends and payments for inter-company services provided as part of the normal course of business or routine cash management functions or current money pool arrangements) to AVA or its affiliates, or assume any obligation or liability as guarantor, endorser, surety or otherwise for AVA or its affiliates; provided that this condition will not prevent Avista Utilities from assuming any obligation or liability on behalf of a subsidiary of Avista Utilities. Any changes to current money pool arrangements will require Commission approval. AVA will not pledge any of the assets of the business of Avista Utilities as backing for any securities which AVA or its affiliates (but excluding Avista Utilities and its subsidiaries) may issue.

STAFF COMMENT: 15.) REMOVED ORIGINAL RELATING TO AI TRANSACTIONS AND INTER-COMPANY LENDING AGREEMENTS.

16.) Nothing in these restructuring commitments shall be interpreted as a waiver of Avista Utilities' or AVA's rights to request confidential treatment for information that is the subject of any commitments.

STAFF PROPOSED CONDITION: 16.) Nothing in these restructuring commitments shall be interpreted as a waiver of Avista Utilities' or AVA's rights to request confidential treatment for information that is the subject of any commitments.

17.) Equity Building Mechanism: The Company agrees that it will increase the actual utility equity component to 35% by December 31, 2007 and to 38% by December 31, 2008. To the extent the Company incurs increased power supply or purchased gas costs that are not recovered in retail rates in a timely manner, it would impair the Company's ability to build equity. Accordingly, the calculations to determine whether the targets are met will be adjusted for any additional deferred power supply or purchased gas costs recorded on the Company's books after January 1, 2006, which have been approved for recovery, but over a period longer than proposed by the Company.

Failure to meet the first target will result in an automatic reduction in base utility rates (spread uniformly across all classes) of 2% effective April 1, 2008. Failure to meet the second target would result in a reduction of 2% effective April 1, 2009. If the Company fails to achieve the first target but meets the second one, the 2% reduction on April 1, 2008 would be reversed prospectively as of April 1, 2009. If it meets the first target but misses the second, the April 1, 2009 reduction would remain in effect until its next general rate case. If the Company misses both targets, the total reduction would equal 4%, which would remain in effect until the next general rate case.

STAFF PROPOSED CONDITION: 17.) AVA and Avista Utilities commit that Avista Utilities will not make any dividends to AVA if Avista Utilities' common equity ratio is below 33%, or would fall below 33% of its Total Adjusted Capital as a result of the dividend, without Commission approval through 2007. Beginning January 1, 2008, AVA and Avista Utilities commit that Avista Utilities will not make any dividends to AVA if Avista Utilities' common equity ratio is below 38%, or would fall below 38% of its Total Adjusted Capital as a result of the dividend, without Commission approval through 2008. AVA and Avista Utilities commit that Avista Utilities will not make any dividends to AVA if Avista Utilities' common equity ratio is below 40%, or would fall below 40% of its Total Adjusted Capital as a result of the dividend, without Commission approval through 2009. Thereafter, AVA and Avista Utilities commit that Avista Utilities will not make any dividends to AVA if Avista Utilities' common equity ratio is below 44%, or would fall below 44% of its Total Adjusted Capital as a result of the dividend, without Commission approval. For purposes of calcu

18.) AVA and Avista Utilities commit that Avista Utilities will not make any dividends to AVA that will reduce Avista Utilities' common equity capital below 25% of its Total Adjusted Capital without Commission approval. This percentage will be adjusted, as necessary, to account for any changes to Generally Accepted Accounting Principles (GAAP) after approval of this transaction. For purposes of calculating the numerator of the percentage, common equity will not include any portion of Avista Utilites preferred stock issued and outstanding. Avista Utilities' Total Adjusted Capital is defined as common equity, preferred equity, long-term debt, short-term debt and capitalized lease obligations.

STAFF COMMENT:

18.) Avista Utilities will not declare or make any distribution to AVA or any other person that owns or holds an equity interest, unless, on the date of such Distribution, either:

1. at the time and as a result of such Distribution, Avista's Interest Coverage Ratio is not less than 2.5:1; or

2. (if Avista is not in compliance with the foregoing ratios) at such time, Avista's senior unsecured long term debt rating is at least BBB (or its then equivalent) with Standard & Poor's Ratings Group and Baa2 (or its then equivalent) with Moody's Investors Service, Inc

"Interest Coverage Ratio" means, with respect to Avista Utilities on any Measurement Date, the ratio of (i) the aggregate amount of Consolidated EBITDA of Avista for the four fiscal quarters for which financial information in respect thereof is available immediately prior to such Measurement Date to (ii) the aggregate Consolidated Interest Expense during such four fiscal quarters.

19.) Through December 31, 2016, Avista Utilities will provide the Commission notice when it increases the amount of any dividend payment by 10% or more over the previously-paid dividend.

STAFF PROPOSED CONDITION:

19.) Through December 31, 2016, Avista Utilities will provide notice to the Commission, and to other parties to this Docket upon request, when it increases the amount of any dividend payment by 10% or more over the previously-paid dividend

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20.) In the event of a credit rating downgrade of Avista Utilities, the Company will schedule a meeting with Staff within one month of the downgrade to discuss the reason for the downgrade and the Company's plans going forward.

STAFF PROPOSED CONDITION:

20.) In the event of a credit rating downgrade of Avista Utilities, ~~the Company~~Avista Utilities will give notice to the parties in this Docket and schedule a meeting with Staff within one month of the downgrade to discuss the reason for the downgrade and ~~the Company's~~Avista Utilities' plans going forward.

21.) On or before April 1, 2008, and on or before every anniversary date thereafter, Avista Utilities will provide to the Commission an annual report for the preceding calendar year, in which it describes its compliance with the provision of items 17, 18 and 19, concerning the equity building mechanism and payment of dividends.

STAFF PROPOSED CONDITION: 21.)——On or before April 1, 2008, and on or before every anniversary date thereafter, Avista Utilities will file with the Commission, and will provide to ~~the Commission~~ other parties to this Docket upon request, an annual report for the preceding calendar year, in which it ~~describes its compliance with the provision of items 17, 18 and 19, concerning the equity building mechanism and payment of dividends.~~

22.) Avista Utilities is required to apply to the Commission for approval of security issuances pursuant to Idaho Code Title 61, Chapter 9. Avista Utilities will not seek an exemption from this requirement for twelve months following the closing of this transaction. Staff will evaluate the "all-in-cost" of issuances for inclusion in rates and the cost of any debt issuance recognized for ratemaking will not be higher than it otherwise would have been without the corporate reorganization.

STAFF COMMENT: 22.) REMOVED 22.

23.) AVA and Avista Utilities will provide the Commission access to corporate minutes including Board of Director's minutes and all committee minutes, along with any related source documents that are relevant to the business and risk analysis of Avista Utilities. Avista Utilities and the Commission Staff will establish an agreeable procedure to review these confidential documents in Spokane, WA upon request.

STAFF PROPOSED CONDITION: 23.) AVA and Avista Utilities will provide the Commission and other parties to this Docket upon request, access to corporate minutes including Board of Director's minutes and all committee minutes, along with any related source documents that ~~are~~ may lead to relevant ~~to~~ information regarding the business and risk analysis of Avista Utilities. Avista Utilities and the ~~Commission Staff~~ party requesting access will establish an agreeable procedure to review these confidential documents ~~in Spokane, WA~~ upon request.

24.) AVA and Avista Utilities will provide the Commission access to operational, internal and risk audit reports and documentation. Avista Utilities and the Commission Staff will establish an agreeable procedure to review these confidential documents upon request.

STAFF PROPOSED CONDITION: 24.) AVA and Avista Utilities will provide the Commission, and other parties to this Docket upon request, access to operational, internal and risk audit reports and documentation. Avista Utilities and the ~~Commission Staff~~party requesting access will establish an agreeable procedure to review these confidential documents upon request.

25.) AVA and Avista Utilities will provide the Commission and Staff with notification of all publicly announced proposals for divestiture, spin-off, or sale of any integral Avista Utilities function. AVA and Avista Utilities will also file for Commission approval of divestiture, spin-off, or sale of any integral Avista Utilities function, which is subject to IPUC jurisdiction. This condition does not limit any jurisdiction the Commission may have.

STAFF PROPOSED CONDITION: 25.) AVA and Avista Utilities will ~~provide~~<u>notify</u> the Commission<u>,</u> and ~~Staff with notification~~<u>other parties to this Docket upon request,</u> of all publicly announced proposals for divestiture, spin-off, or sale of any integral Avista Utilities function. ~~AVA and Avista Utilities will also file for Commission approval of divestiture, spin-off, or sale of any integral Avista Utilities function, which is subject to IPUC jurisdiction. This condition does not limit any jurisdiction the Commission may have.~~

26.) Avista Utilities or AVA will notify the Commission prior to implementation of plans by Avista Utilities or AVA: (1) to form an affiliate for the purpose of transacting business with Avista Utilities' regulated operations; (2) to commence new business transactions between an existing affiliate and Avista Utilities; or (3) to dissolve an affiliate which has transacted substantial business with Avista Utilities.

STAFF PROPOSED CONDITION: 26.) Avista Utilities or AVA will notify the Commission<u>, and other parties to this Docket upon request,</u> prior to implementation of plans by Avista Utilities or AVA: (1) to form an affiliate for the purpose of transacting business with Avista Utilities' regulated operations; (2) to commence new business transactions between an existing affiliate and Avista Utilities; or (3) to dissolve an affiliate which has transacted substantial business with Avista Utilities.

a. <u>Nothing in these Conditions prevents Avista Utilities from having its own subsidiaries. However, no AVA holding (*i.e.*, a subsidiary held directly by AVA or a subsidiary held indirectly by AVA, such as a subsidiary of an AVA subsidiary) shall be conveyed to Avista Utilities or a subsidiary of Avista Utilities, without prior Commission approval.</u>

27.) Avista Utilities or AVA will notify the Commission subsequent to AVA's or Avista Utilities' board approval and as soon as practicable following any public announcement of: (1) any acquisition of a regulated or unregulated business representing 5 percent or more of the capitalization of AVA; or (2) the change in effective control or acquisition of any material part or all of Avista Utilities by any other firm, whether by merger, combination, transfer of stock or assets.

STAFF PROPOSED CONDITION: 27.) Avista Utilities or AVA will notify the Commission, and other parties to this Docket upon request, subsequent to AVA's or Avista Utilities' board approval and as soon as practicable following any public announcement of: (1) any acquisition of a regulated or unregulated business representing 5 percent or more of the equity book value capitalization of AVA; or (2) the change in effective control or acquisition of any material part or all of Avista Utilities by any other firm, whether by merger, combination, transfer of stock or assets.

28.) Avista Utilities will provide to the Commission, upon request, on an informational basis, credit rating agency news releases and final reports regarding Avista Utilities when such reports are known to Avista Utilities and are available to the public.

STAFF PROPOSED CONDITION: 28.) Upon request, Avista Utilities will provide to the Commission, ~~upon request,~~ and other parties to this Docket on an informational basis, credit rating agency news releases and final reports regarding Avista Utilities when such reports are known to Avista Utilities and are available to the public.

29.) AVA and Avista Utilities commit that in the event that Avista Utilities obtains a loan from its parent company or any affiliated company, Avista Utilities will, in any subsequent rate proceeding demonstrate that the debt obligation interest, terms, and conditions are comparable to or less than what Avista Utilities could have obtained in the market at the time the debt was obtained by Avista Utilities, that the loan is on reasonable terms and without markup to the holding company's cost of funds, and that the debt procurement will not interfere with any ring-fencing mechanisms that secure the utility.

STAFF PROPOSED CONDITION: 29.) AVA and Avista Utilities commit that in the event that Avista Utilities obtains a loan or transfer of funds from its parent company or any affiliated company, Avista Utilities will, in any subsequent rate proceeding demonstrate that the debt obligation interest, terms, and conditions are comparable to or ~~less~~more favorable than what Avista Utilities could have obtained in the market at the time the debt was obtained by Avista Utilities, that the loan is on reasonable terms and without markup to the holding company's cost of funds, and that the debt procurement will not interfere with any ring-fencing mechanisms that secure the utility.

30.) AVA and Avista Utilities will enter into an agreement that incorporates the ring-fencing provisions set forth herein, which agreement shall be binding upon AVA and Avista Utilities, and their respective Boards of Directors. This agreement will be filed with the Commission within three months of closing of the transaction. AVA and Avista Utilities commit that no amendments, revisions or modifications will be made to this agreement or any ring-fencing provisions without prior Commission approval for the sole purpose of addressing the ring-fencing provisions.

30.) AVA and Avista Utilities will enter into an agreement that incorporates the ring-fencing provisions set forth herein, which agreement shall be binding upon AVA and Avista Utilities, and their respective Boards of Directors. This agreement will be filed with the Commission within three months of closing of the transaction. AVA and Avista Utilities commit that no amendments, revisions or modifications will be made to this agreement or any ring-fencing provisions without prior Commission approval for the sole purpose of addressing the ring-fencing provisions.

STAFF PROPOSED CONDITION:

31.) Within three months of closing of the transaction, AVA commits to obtain a non-consolidation opinion that

a) Notify the Commission of this inability to obtain a non-consolidation opinion.

b) Propose and implement, upon Commission approval, such ring-fencing provisions that are sufficient to prevent

c) Obtain a non-consolidation opinion.

STAFF PROPOSED CONDITION: Condition 31 is accepted as written.

32.) Unless another process is provided by statute, Commission regulations or approved Avista Utilities' tariff, AVA and Avista Utilities encourage the Commission to use the following process for administering the commitments. The Commission should give AVA and Avista Utilities written notification of any violation by either company of the commitments made in this application. If such failure is corrected within ten (10) business days for failure to file reports, or five (5) business days for other violations, the Commission should take no action. The commission shall have the authority to determine if the corrective action has satisfied or corrected the violation. AVA or Avista Utilities may request, for cause, an extension of these time periods. If AVA or Avista Utilities fails to correct such violations within the specified time frames, as modified by any Commission-approved extensions, the Commission may seek to assess penalties for violation of a Commission order, against either AVA or Avista Utilities, as allowed under state laws and regulations.

The applicants agree that the Commission shall have an opportunity and the authority to consider and adopt in Idaho any commitments or conditions to which the Applicants agree or with which the Applicants are required to comply in other jurisdictions, even if such commitments and conditions are agreed to after the Commission enters its order in this docket. To facilitate the Commission's consideration and adoption of the commitments and conditions from other jurisdictions, the Parties urge the Commission to issue an order accepting this Stipulation as soon as practical, but to reserve in such order the explicit right to re-open to add commitments and conditions accepted or ordered in another state jurisdiction.

STAFF COMMENT: ORIGINAL 32 (RE: VIOLATIONS) REMOVED.

ADDITIONAL STAFF-PROPOSED CONDITIONS:

32.) If the Commission believes that AVA and/or Avista Utilities have violated any of the commitments of the stipulation, or any conditions imposed by the Commission in its final order approving the Application (collectively, the "Conditions"), then the Commission shall give AVA and Avista Utilities written notice of the violation.

i.) If the violation is for failure to file any notice or report required by the Conditions, and if AVA or Avista Utilities, or both provide the notice or report to the Commission within ten business days of the receipt of the written notice, then the Commission shall take no action. AVA or Avista Utilities may request, for cause, permission for extension of the ten-day period. For any other violation of the Conditions, the Commission must give AVA and Avista Utilities written notice of the violation. If such failure is corrected within five business days of the written notice, then the Commission shall take no action. AVA or Avista Utilities may request, for cause, permission for extension of the five-day period.

ii.) If AVA or Avista Utilities, or both, fail to file a notice or written report within the time permitted in subparagraph a. above, or if AVA or Avista Utilities, or both, fail to cure, within the time permitted above, a violation that does not relate to the filing of a notice or report, then the Commission may open an investigation, with an opportunity for AVA or Avista Utilities, or both, to request a hearing, to determine the number and seriousness of the violations. If the Commission determines after the investigation and hearing (if requested) that AVA or Avista Utilities, or both, violated one or more of the Conditions, then the Commission shall issue an Order stating the level of penalty it will seek. AVA or Avista Utilities, or both, as appropriate, may appeal such an order under ORS 756.580. If the Commission's order is upheld on appeal, and the order imposes penalties under a statute that further requires the Commission to file a complaint in court, then the Commission may file a complaint in the appropriate court seeking the penalties specified in the order, and AVA or Avista Utilities, or both, shall file a responsive pleading agree

iii.) The Commission shall not be bound by the process provided in paragraph ii in the event the Commission determines Avista Utilities has violated any of the material conditions more than two times within a rolling 24-month period.

iv.) Avista Utilities or AVA, or both, shall have the opportunity to demonstrate to the Commission that the process provided in paragraph ii should not apply on a case-by-case basis.

33.) The Applicants agree that the Commission shall have an opportunity and the authority to consider and adopt in Oregon any commitments or conditions to which the Applicants agree or with which the Applicants are required to comply in other jurisdictions, even if such commitments and conditions are agreed to after the Commission enters its order in this docket. To facilitate the Commission's consideration and adoption of the commitments and conditions from other jurisdictions, the Parties urge the Commission to issue an order accepting this Stipulation as soon as practical, but to reserve in such order the explicit right to re-open to add commitments and conditions accepted or ordered in another state jurisdiction.

34.) In the event of a dispute between Commission Staff and AVA or Avista Utilities regarding a Commission Staff request made pursuant to acquisition conditions or commitments, the parties agree that an Administrative Law Judge (ALJ) shall resolve the dispute as follows: (i) within ten (10) business days AVA or Avista Utilities shall deliver to the ALJ the books and records responsive to Staff's request and shall indicate the basis for the objection, including whether the request is overbroad, unduly burdensome or outside the scope of the Commission's jurisdiction; (ii) Staff may respond in writing and AVA or Avista Utilities, or both, may reply; (iii) the ALJ shall review the documents in private; and (iv) the ALJ shall issue a ruling determining whether the documents are, directly or indirectly, relevant to Avista Utilities or reasonably calculated to lead to the discovery of admissible evidence directly or indirectly relevant to Avista Utilities. The ALJ shall use this standard whether or not Staff is making the request in connection with an open docket. Nothing in this provision shall affect the right of AVA or Avista Utilities

35.) AVA and Avista Utilities to contest any motion or ruling that asserts that the Commission does not retain its authority over Avista Utilities in the event of either voluntary or involuntary bankruptcy proceedings affecting either AVA or Avista Utilities.

36.) Avista Utilities agrees that it will not voluntarily enter into bankruptcy proceedings affecting either AVA or Avista Utilities without first demonstrating to the Commission's satisfaction that doing so will benefit customers.

37.) ~~AVA and~~Before December 31, 2009, neither Avista Utilities ~~commit to use asymmetrical pricing (i.e., lower~~ nor any of ~~cost~~ its subsidiaries will enter into any electric or ~~market for~~natural gas commodity transactions ~~to Avista Utilities and higher of cost~~, either physical or ~~market for transactions from Avista Utilities) for affiliate charges~~ financial, with AVA or ~~costs not covered by the provisions of any cost sharing agreement, if a readily identifiable market for the goods, services or assets exists, and if the transaction involves a cost of more than $100,000~~its other affiliates or subsidiaries, including Avista Energy and Avista Power. This Condition does not affect any other existing or future limitations on Avista Utilities' energy transactions or trades imposed by the Commission or otherwise.

CASE: UM 1250
WITNESS: Thomas D. Morgan

PUBLIC UTILITY COMMISSION OF OREGON

STAFF EXHIBIT 103

Exhibits in Support of Direct Testimony

March 20, 2007

STANDARD
&POOR'S

American Gas Association Financial Forum

The Westin Kierland Resort
Scottsdale, AZ

May 7, 2006

Understanding the Ratings Process

The McGraw-Hill Companies

Standard & Poor's Ratings Services

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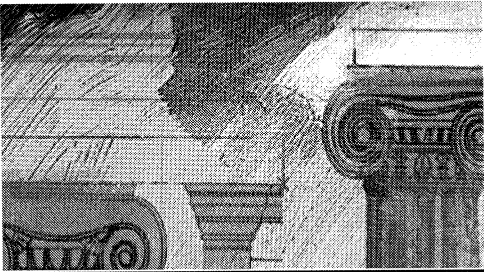
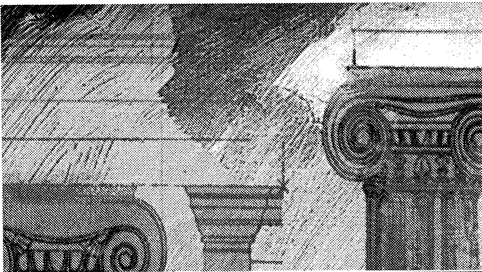


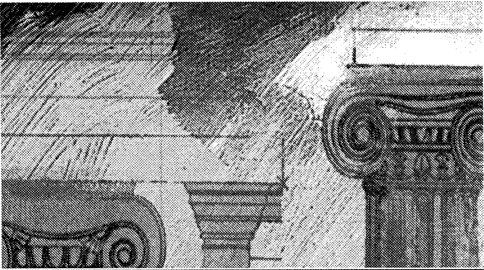
Standard & Poor's Role in Credit Markets

- Provide independent opinion
- Evaluate creditworthiness
- Determine the "risk of default"
- Analyze business and financial risk
- Ratings used by investors as a guide



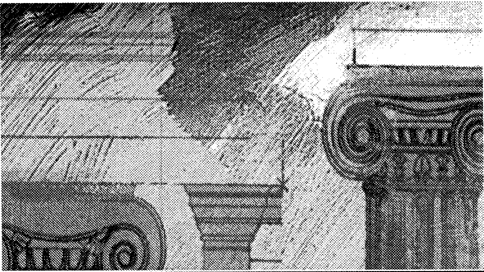
Consolidated Ratings Approach

- Cash Is flexible & fungible; cash flow & needs are managed efficiently
- One unit's cash surplus supports another's cash needs
- Capability, not culpability
- Burden of proof for regulatory insulation
- Standard & Poor's Bottom Line:
  A company's ability to meet its obligations is generally the same throughout the organization



Insulation Factors

- Regulatory
  - Before-the-fact
  - Limitations on upstream dividends
  - Mandated leverage and coverage tests
- Structural
  - Ring-fencing
  - Legal separation
  - Economic disincentives
- Strategic Importance
  - Management control
  - Investment size
  - Financial obligation
  - Stated posture

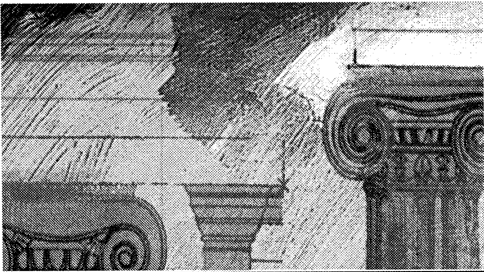


Credit Rating Process

- Less ratio driven
- Qualitative factors have greater weight
- Time horizon shortened to 1-3 years
- Management execution is crucial
- Enhanced analytic approach
- Liquidity important for LDCs

Favorable Credit Attributes

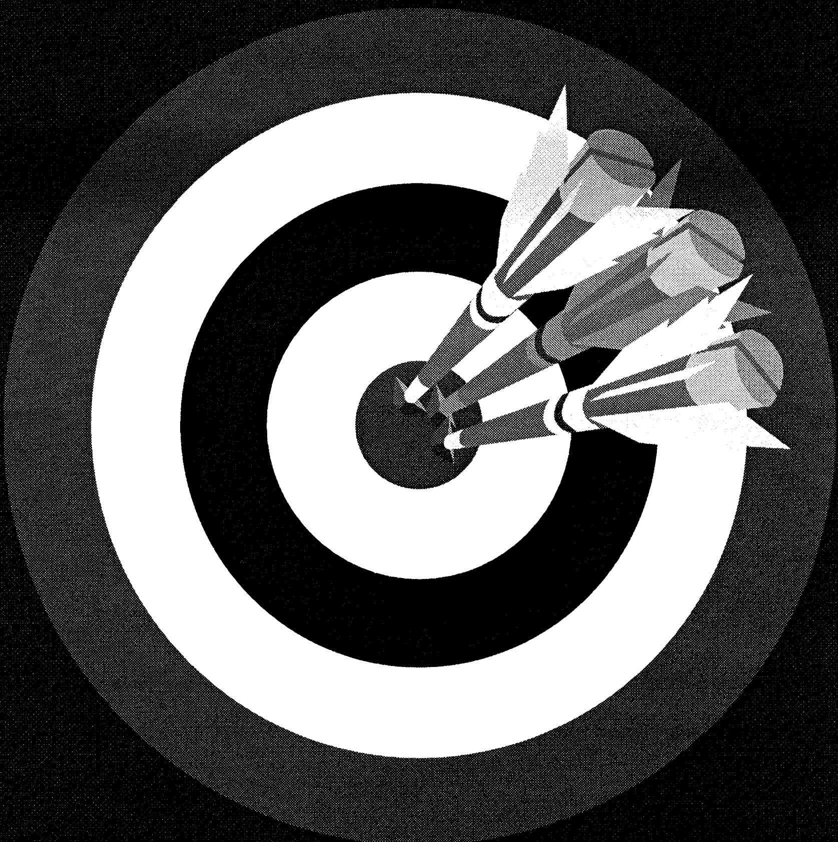
- Constructive regulation
  - Purchased gas clause
  - Weather normalization clause
  - Above average ROEs
- Growing service territory
- Access to multiple interstate pipelines
- Adequate storage availability
- Sizable liquidity

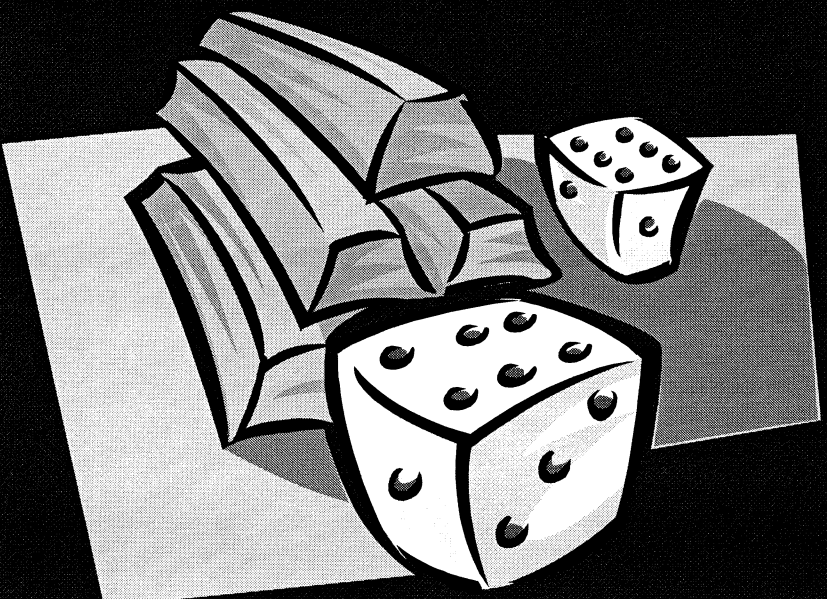


Healthy Regulated Company

- Reliable regulatory decisions adjudicated in a timely manner
- Solid and predictable cash flow generation
- Ready access to capital markets
- Steady, straightforward business strategy
- Transparent balance sheet
- Effective liability and liquidity management

How Does S&P Determine Ratings

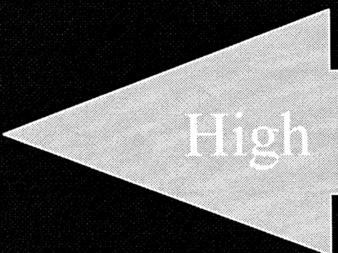


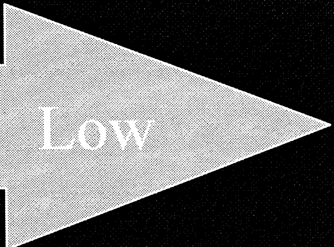


Energy Industry Business Risk Scale

GAS

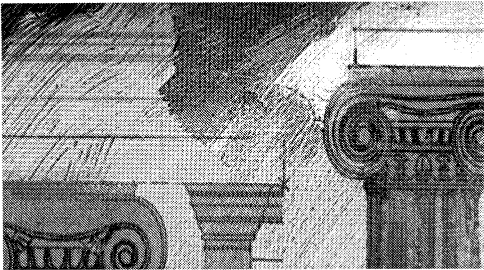
E&P | Processing & Gathering | Transmission | Distribution





Energy Marketing | Generation | Transmission | Distribution

ELECTRIC



Establishing The Business Profile

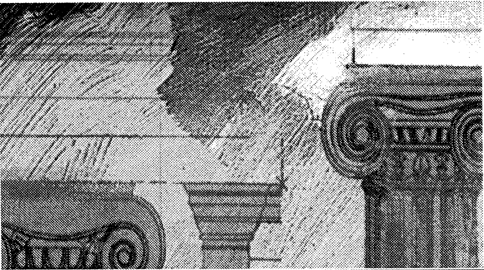
- Risk assessment of communicated business strategy
- Ability to execute on plans in a timely manner
- Commitment and attitude towards credit quality
- Past performance
- Heavily weighting the factors that are driving credit quality
- Must recognize the unit's risk exposure regardless of size.

Business Risk Components

- Regulation
- Markets
- Operations
- Competitive Position
- Management
- Diversified (Non-regulated) Ventures

Importance of Regulation

- Without regulatory safety net and monopolistic service territory ratings would start in BB category
- Provide level of support during distress
- Allow deferred cost recovery
- Opportunity to earn a set return on assets
- Maintaining financial strength



Regulatory Risk is Greater Today

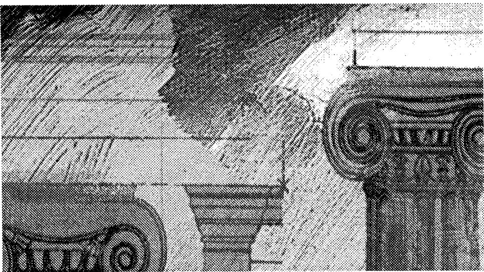
- Volume of rate cases
- Experience level of staff
- Understanding of basic financial principals
- Rising pension and health care costs
- Politicized environment

Understanding Strategy

- Where will growth come from
- How solid is the regulatory compact
- Ability to manage volatile gas prices
- Attitude towards credit quality

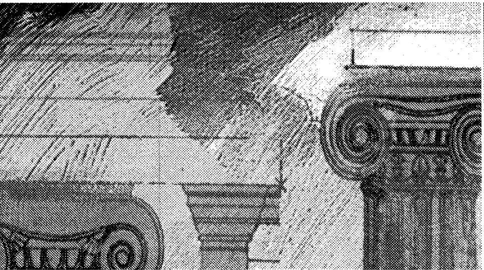
Management Challenges

- Commodity Pricing
- Recovery
- Storage
- Growth
- Regulatory Relationships

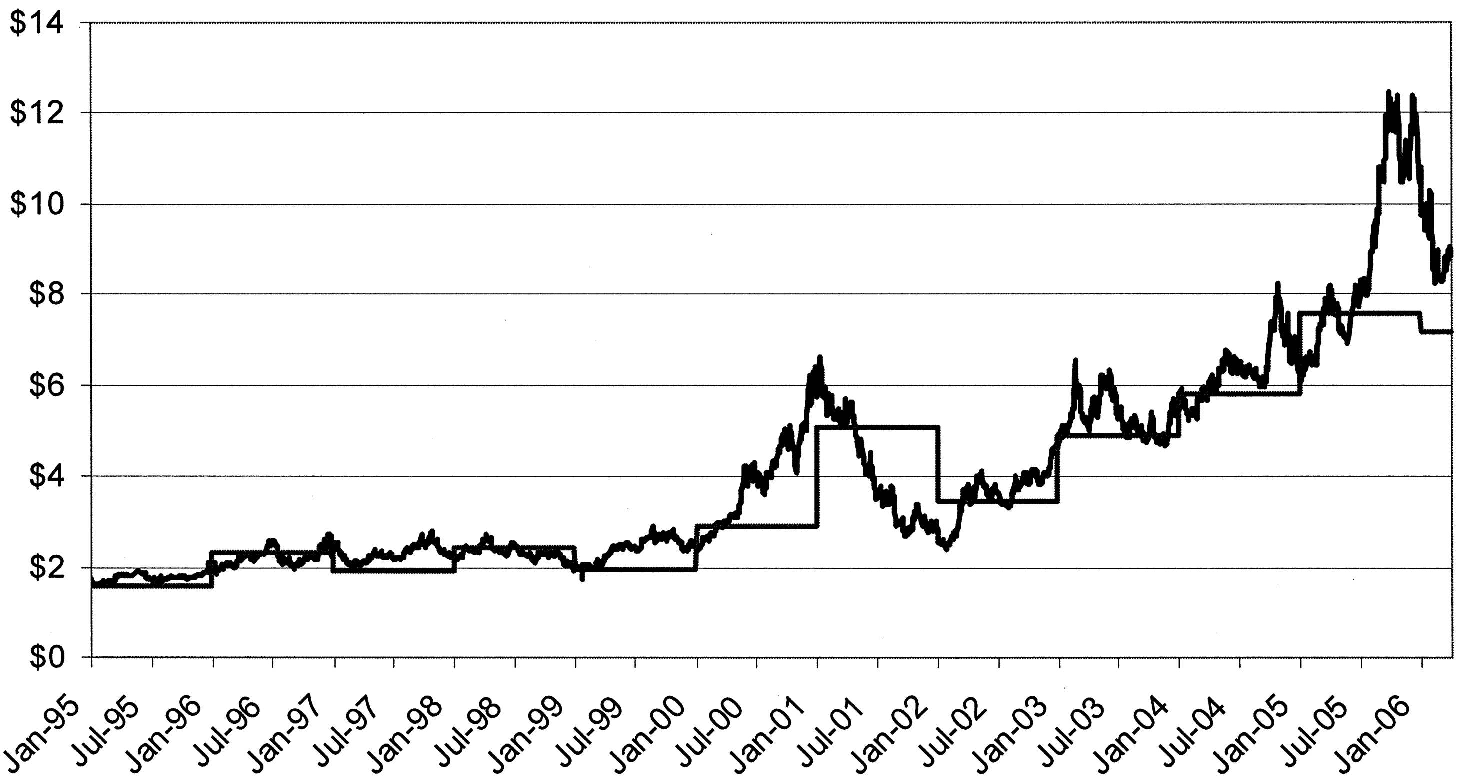


Financial Policy

- Funding high cost of gas
- Liability management
- Liquidity
- Financial coverage ratios

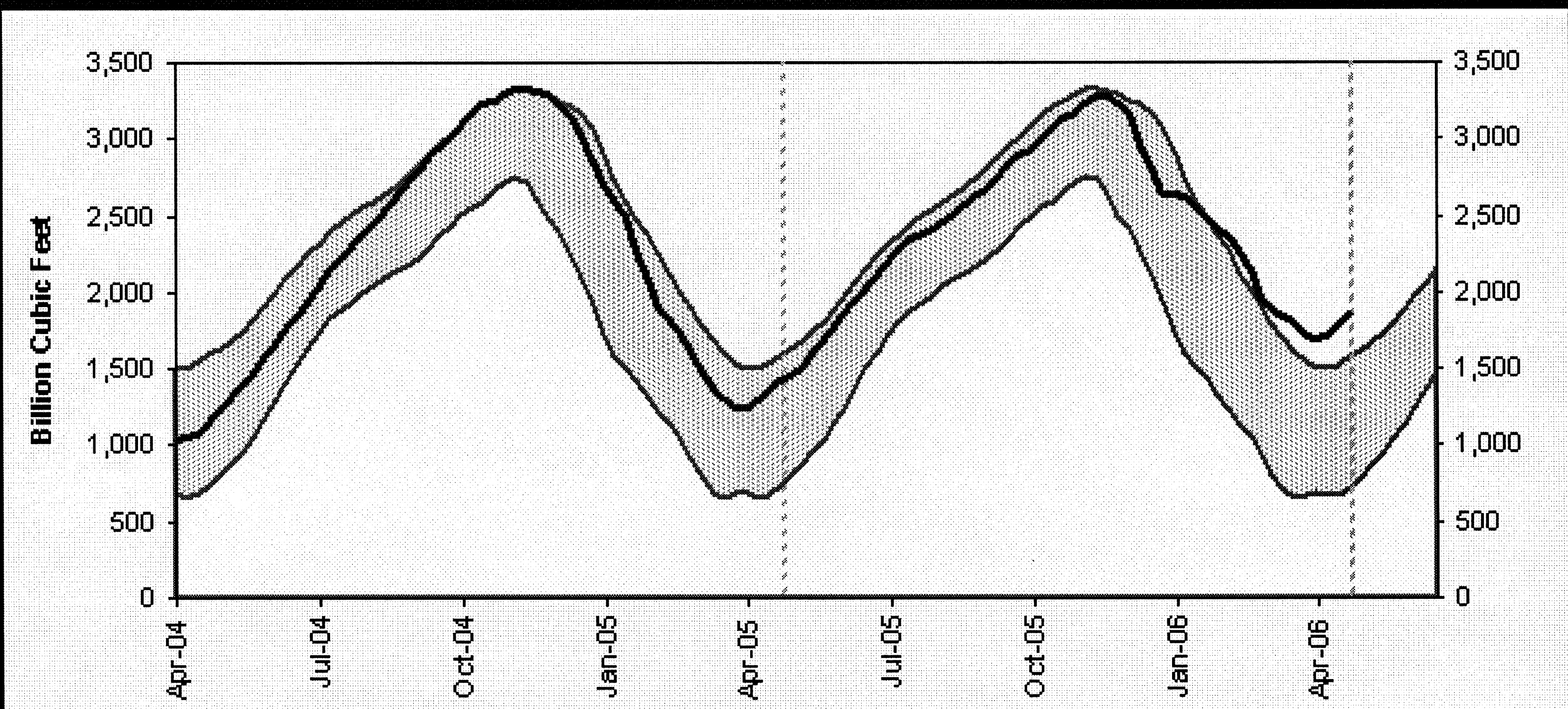


Commodity Pricing



Storage Levels for 2006 Heating Season

Working Gas in Underground Storage Compared with 5-Year Range



Source : EIA

Liability Management

- Important indicator of credit quality
- Issuers approach to liability management has a direct correlation with level of embedded risk
- Vulnerability to refinancing risk
- Debt duration and maturity profile
- Contingent liabilities & off-balance sheet obligations

Coverage Ratios

- Profitability and Cash Flow ratios remain important factors

  FFO/TD
  FFO/Interest Coverage
  Internal Funding (NCF/Cap Ex)
  EBIT Interest Coverage

Industry Trends Potentially Affecting Credit Quality

- Regulatory/Political Environment – front and center
- Commodity prices
- Capital spending and related financing activities
- Event Risk (M&A, Asset Rationalization)
- Shareholder value emphasis

The Re-Emergence of the Regulatory Arena

- Utilities across the country are filing rate cases following a prolonged hiatus
- Major rate cases are likely to be a sustained characteristic of utility activity
- Regulators will be challenged to balance priorities:
  - Customer protection
  - Reliability
  - Conservation
  - Financially healthy utilities

Regulatory Uncertainty

- The character of regulatory decisions will perhaps be the major determinant of utility credit quality for many years
- Uncertainty deprives utilities of credit strength
- Uncertainty is created by unsupportive actions:
  - Delaying decisions (Regulatory Lag);
  - Prudency disallowances;
  - Absence of pre-approved infrastructure investments

Regulatory Challenges

- Soaring Natural Gas Prices > Elevated Wholesale Rates > High Anxiety Among Ratepayers >>>POLITICAL STRESS
  - Illinois
  - Maryland
  - Delaware

  PLUS …

- Aging Infrastructure and Concern Over Long-Term Reliability & Rate Base Additions (Generation, Transmission, Environmental) >>> POLITICAL STRESS

Taking Utilities Private: Return of the Barbarians

Experts debate whether KKR's leveraged buyout of UniSource Energy is right for the industry.

January 2004, By *Richard Stavros, http://www.pur.com/pubs/4330.cfm*

"From a public policy standpoint, should a utility that provides a vital public good be owned by a private group that gains ownership by taking on a high degree of debt (risk)?"

Mark T. Williams, executive-in-residence at the Finance & Economics Department at Boston University, identifies the quintessential issue that will no doubt be heatedly debated in boardrooms and commissions as more utility CEOs are tempted to become private utilities through a leveraged buyout transaction.

And tempted they will be.

Morgan Stanley estimates that the top 10 largest private equity groups seeking to invest in the sector have a total buying power of $198 billion (see chart 1, p. 25). While this amount is for total investment in all business sectors, many experts say billions are being earmarked for utility industry investment even as significant amounts of private equity investment already have been spent (see chart 2, p. 25).

Moreover, Williams says, given that interest rates are currently at 40-year lows, and utility sector debt spreads over risk-free treasuries have declined in recent months makes highly leveraged transactions more attractive.

In a typical leveraged buyout (LBO) a small group of investors, usually including current management, acquires a firm in a transaction financed largely by debt. The debt is serviced with funds generated by the acquired company's operations, and in some cases, by the sale of some of its assets. In other instances, the LBO firm plans to sell off divisions to other firms that can gain synergies. The acquiring group expects to make a profit from the LBO, but the inherent risks can be great due to the heavy use of financial leverage, according to a textbook definition. LBO specialists are quick to point out that the amount of financial leverage in recent deals has been much lower than in the past.

Putting it another way, leveraged buyers in the last few years have faced less-favorable terms. For example, in the last three years LBO firms parted with equity worth an average 41 percent of the deal price, according to a Standard & Poor's report. This is a significant change from the 10 percent equity that defined the typical 1980s LBO.

Certainly, many industry insiders disagree over whether the heavy use of financial leverage would pose any risk to utilities, which as a matter of historical record have always been highly leveraged, capital-intensive businesses. Furthermore, they say the capital structure of a utility is but one of many considerations a regulator makes to determine if an acquisition is in the public interest.

But other criticisms come down to trust. Can the so-called "barbarians at the gate" be trusted?

Some utility executives have raised concerns over the possibility of holding-company abuses by private equity groups that haven't been raised since the 1930s, when such abuses were terminated by the passing of the 1935 Public Utility Holding Company Act (PUHCA). Conversely, proponents of LBOs say that private or public ownership has little to do with corporate abuse, pointing out that corporate scandals in the last few years came largely from publicly traded companies such as Enron.

Moreover, other critics heatedly complain that private equity firm support for a utility could dry up after privatization when interest rates increase, causing a liquidity crisis. "While existing company debt will have been refinanced at lower rates in conjunction with the LBO, private equity firms will be harder pressed to raise more money as interest rates rise and thus will constrain the utility's access to capital," says one analyst. Private equity proponents respond, "We always have access to public equity markets and can take the company public again in order to raise capital in the public markets." Furthermore, "The company will continue to have access to public debt markets and can go back to their private equity sponsors for additional equity if needed," argues another LBO expert.

So why a private equity investor in a high-interest-rate environment would continue to leverage its acquisition or provide equity at a higher cost of capital, when such an investment fails to outperform treasuries is anybody's guess, queries one.

Fairly or unfairly, private equity investors using heavy financial leverage to acquire companies have raised debate in almost every industry where such transactions have been introduced. The focus of the concern has always centered on implementation. The utility industry is no different. If anything, experts say, private equity groups will be more heavily scrutinized because of the high degree of regulatory oversight over utilities involved in protecting the public interest.

That is why the LBO by Kohlberg Kravis Roberts & Co. (KKR) and its investor group purchase of Arizona-based UniSource Energy, parent company of regulated utility Tucson Electric Power, is a good test case to debate whether, and in what circumstances, the LBO structure may or may not be appropriate for the utility industry from a business and policy perspective.

The KKR Deal: The Art of Going Private

On Nov. 24, 2003, the board of UniSource Energy accepted an offer to acquire the company from a private investor group that includes KKR, J.P. Morgan Partners LLC, and Wachovia Capital Partners as limited partners, plus general partner Sage Mountain L.L.C, an Arizona company owned and managed by Frederick B. Rentschler, a former corporate CEO. The approximate $3 billion transaction would leave UniSource Energy's senior management team in place, and the company's headquarters would remain in Tucson. This transaction will be financed with approximately $560 million of partner equity and $660 million in new debt. The leverage added to UniSource from the deal causes the company's debt on a consolidated basis to exceed 80 percent, according to analysts.

"Ironically, while other industry players such as Duke Energy and El Paso are shedding debt as quickly as possible, here is an example of a strategy that embraces debt to achieve an objective," says Boston University's Williams. A private equity specialist adds that an appropriate level of debt can impose a discipline on companies to remain more focused on their core business rather than divert capital and management resources into unrelated businesses.

Still, Williams says the real test will be how this company will be able to become profitable, given that it is financing $970 million, including new debt of $660 million.

"While the purchase price is approximately $885 million in cash to shareholders plus assumed debt, total consolidated debt will exceed $2 billion. To meet these debt payments, any additional income generated will have to come from the cost side, not the revenue side, as utility rates are highly regulated. Additionally, costs related to plant and line maintenance are closely scrutinized to ensure that adequate capital is spent for reliability.

"In a sense, the fact that existing management has not been successful in turning this company around, as measured in stock performance, the LBO is at least acknowledgement that radical changes needed to occur. Shareholders are now able to cash out at a premium and reinvest their money elsewhere," Williams says.

Daniel More, head of utility M&A at Morgan Stanley, who advised Unisource Energy on the deal, says it was precisely because the company was not being paid attention to in the public equity markets that privatization is a compelling alternative.

"Let's face it; Wall Street research is getting to be harder and harder to come by. Mid-size to smaller utilities are often not covered by any sell-side analysts. It's also difficult to have adequate trading liquidity in the stock of such companies, both of which contribute to lack of institutional investors' interest. With lack of interest in your stock, if you don't have clear avenues for growth, you start to think about the world out there and potential pools of capital. There is public equity and there is private equity," More says.

Furthermore, many advocates of the deal point out that it strengthens the capital base of the company's regulated utility. But opponents point out that the leverage is moved from the utility subsidiary to the holding company. "KKR is not putting equity into the utility out of the goodness of their hearts. They're providing that equity to overcome restrictions on the dividend amount paid to the holding company to further leverage the holding company," says another.

The equity that will be attributed to Tucson Electric Power Co. (TEP) is $260 million, including the retirement of a $95 million inter-company loan from TEP to UniSource Energy. According to Kevin P. Larson, vice-president, CFO, and

treasurer of UniSource Energy, "The Arizona Corporate Commission limits dividends (from TEP to UNS) to 75 percent of TEP net income if TEP equity is less than 40 percent of total capitalization (excluding leases). Today TEP's equity represents approx 25 percent of capitalization per Arizona Corporation Commission calculation. Following the merger it is anticipated that TEP equity will be equal to or greater than 40 percent. At that point, TEP could pay 100 percent of net income as a dividend, provided no other restrictions exist," he says. At press time, the application to the Arizona Corporate Commission for the acquisition of UniSource Energy by KKR had not been filed, neither had the proxy statement, but both were expected sometime in early February. However, a notice of intent has been filed, and the company said all documents would be available on the UniSource Energy Web site (www.unisourceenergy.com).

KKR executives say the deal is predicated on no change to UniSource Energy's current business model or rate structure, and KKR does not intend to make any changes that jeopardize reliability or its relationship with regulators.

"Our business model is not in this context to cut costs. You don't make any money at a utility by cutting some costs around the edges. For us, this is all about putting a large amount of capital to work for a long period of time at a reasonable rate of return. The reasonable rate of return comes from just earning your regulated return and then putting an appropriate financial structure in place," says Marc S. Lipschultz, partner at KKR.

"I think the only risk is that we as investors do not make an acceptable return. There is no downside for the customers of this company because as part of this transaction we are actually infusing equity in TEP for them to pursue their goals in providing good customer service and reliability. And they have a rate freeze, so there is no change to rates. There is only an upside for customers and ratepayers," he says.

Furthermore, Lipschultz adds that KKR will not be a fly-by-night operation, which buys out the company, carves up the pieces, and sells the parts for more than the whole.

"Our average hold period is seven to eight years. We have held some businesses as long as 15 years. We think a portion of our portfolio can be in lower risk and lower return utilities. ... If one takes a very long and steady view and really understands the sector, we think there is really good fit between our kind of capital, which is long-term patient capital, with the needs of the energy sector," he says. But while no one may doubt KKR's good intentions, some regulators, who asked to remain anonymous, are concerned over whether the amount of leverage being used is appropriate, even as other regulators say ring-fencing laws make the question irrelevant.

Leveraging Up to the Nose: The Great Debt Debate

Even as KKR presents a very conservative approach in its future ownership of the utility, the company's use of heavy financial leverage still leaves many regulators and financial analysts uneasy. One banker, using public data, forecasts KKR's levered return on total invested capital to be as high as 18 percent (see Box, p. 27). While a private equity specialist familiar with the deal says the base-case return will be 16 percent.

Some argue that the forecast of almost 16 to 18 percent return that KKR will receive could be a "windfall." Others point out that the returns forecasted are not guaranteed, and that KKR will always live with regulatory risk.

Branko Terzic, global regulatory policy leader for Energy & Resources at Deloitte and a former FERC and Wisconsin state commissioner, says that the regulator always has the ultimate regulatory tool: the power to reduce rates if he or she feels there is abuse. Furthermore, he believes that regulators should be primarily focused on the regulated utility. "Most LBO entities are not expert operators: They are financial investors. The regulator doesn't care if you mortgaged your house to buy shares in the regulated utility, or whether you inherited your stock from your grandfather Rockefeller. How you financed the stock that you purchased is irrelevant to the regulator as long as the equity structure of the [regulated] utility is appropriate," he says. "There is, of course, the issue of 'control' when a single stockholder owns the utility, but once again the regulator in most states has a full array of regulatory tools to protect the public interest."

Jim McGinnis, managing director at Morgan Stanley, says that targeted returns in the order of 20 percent are anything but guaranteed, especially as there is more to worry about than just the regulator.

"The regulator might be motivated by perceived excess leverage to reduce rates, but negative regulatory impact can come from other sources: a serendipitous change of rulemaking framework on the timing of recovery of fuels, the pricing of fuel inputs, the willingness to extend rate freeze agreements or engage in prospective rate stabilization discussions. So, regulatory rate actions are not only linked to excess leverage," he says.

Furthermore, debt is not necessarily a bad thing, McGinnis says, explaining that regulators often encourage added leverage at the regulated utility level in an effort to lower the cost of delivering electricity to customers who otherwise might have been charged a higher amount.

"The concern dating back to the 1930s was that if a holding company used excessive leverage, there was the potential for undue risk being shared by the utility that was not apparent to the local regulator. And this heightened risk of financial distress at the parent was a burden that the utility was inherently bearing, completely outside the scope of regulation. This extra-jurisdictional risk was one of the primary reasons why the federal government began regulating holding companies. In today's market, we have effective structuring techniques applied to today's ring-fenced utilities that are protective and which ensure against that kind of credit deterioration from above, and investor constituencies - lenders and shareholders-who carefully monitor these inter-creditor issues," McGinnis says.

Some regulators council that if KKR or any other highly leveraged company is perceived to be taking advantage of the regulated utility and earning a "windfall," the double leverage standard may be applied. Double leverage is the use of debt by both the parent company and the subsidiary, in combination with the company's equity capital, to finance the assets of the subsidiary. The purpose behind the double leverage adjustment is to account for the parent's accessibility to lower cost debt to purchase equity in its subsidiary, upon which it may earn a higher rate of return than it pays for the debt.

Alliant Energy's Interstate Power & Light and MidAmerican Energy, which itself was taken private, recently protested the use of double leverage by the Iowa Utilities Board. Nevertheless, the board agreed with consumer advocates that it is the best approach to recognize the true capital structure at the subsidiary level, and to prevent the parent company's stockholders from earning a "windfall," or excessive returns at the expense of ratepayers. "The Board sees no reason on this record to disavow the application of double leverage in all instances. Double leverage is one regulatory tool to help protect the utility from abuse by its parent company," the Iowa Utility Board wrote recently. But the use of double leverage has always been a source of controversy in regulatory circles.

Additionally, many have pointed out that the KKR deal with UniSource Energy has a material adverse change (MAC) clause, which nullifies the deal if there is a change to the business or to rates. This result may not be likely to occur.

Heather Murphy, public information officer at the Arizona Corporation Commission, says as far as TEP's rates are concerned, "the commission's decision on electric competition and subsequent settlement with Tucson Electric Power ushered in a two-step rate decrease-one percent in 1999 and one percent in 2000. Thereafter, TEP's rates are locked in at the current tariff levels until after Dec. 31, 2008. If the company seeks a change in rates or rate structure to take effect after Dec. 31, 2008, TEP would have to file a rate case in late 2006 or early 2007."

Of course, the KKR MAC clause expires when the deal is consummated. "Regulatory risk will be a part of their life," says one. Of course, some regulators say there may be benefits to dealing with one owner.

"A rational, individual regulator might well decide that it is preferable to be negotiating with one rational, economically motivated counterpart, rather than a board and management team working on behalf of 10,000 disparate shareholders. But regulatory bodies are groups of individuals, and these groups have their own historic, institutional biases. It's harder to apply the Rational Man rule. These institutional relationships are difficult to suddenly change in a dramatic way," says McGinnis. As such, he says, LBOs will not be for every utility, and the relationship with regulators may be at the heart of any deal.

"Companies that are weaker candidates for an LBO include some utilities that have relatively uncertain regulatory horizons, and, in particular, utilities that have had a difficult relationship with regulators. On the other hand, under some circumstances, utilities that are in the midst of difficult regulatory relationships can improve their circumstances through the introduction of new senior management that may be able to adopt a fresh perspective and do a better job of interacting with regulators in a constructive way than past management. It's not a forgone conclusion that weaker regulatory relationships would rule out an LBO, but it is certainly the first touch point," McGinnis says.

Can 'Ring-Fencing' Protect Ratepayers From Risk?

Some believe that regulators should not concern themselves with the leverage at the holding company, and instead operate on the assumption that the regulated utility is ring-fenced and thus, perfectly insulated from the troubles at a holding company. Many often point out that the bankruptcy of Enron did not have a significant impact on utility subsidiary Portland General Electric because of tight ring-fencing measures.

But credit rating agencies caution regulators from overconfidence in the structural separation at the utility.

Fitch Ratings, in a meeting with state regulators last year, said there is no perfect ring-fence that can completely insulate a utility. According to Fitch, companies have an inalienable right to force a subsidiary into bankruptcy. A company cannot waive this right, according to the general counsel at Fitch. The National Association of Regulatory Utility Commissioners' (NARUC) Subcommittee on Accounting and Finance last year investigated the issue of ring-fencing in an attempt to identify best practices.

According to its analysis, the NARUC subcommittee found that "the regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements in any acquisition. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk to the utility... This could also require tightly drafted set of covenants subject to commission review."

Moreover, according to a presentation to the NARUC subcommittee, Standard & Poor's named three states that they believe have adequate regulatory insulation mechanisms. Of those states, Wisconsin, Oregon, and Virginia, the report noted that the first two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

The NARUC subcommittee suggests several ring-fencing measures (some are more strenuous forms of others):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any nonutility business.
2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to maintenance of a minimum equity ratio balance.
3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between utility and affiliate companies.
4. Commission authority over the establishment of a holding company structure involving a regulated utility.
5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

Panos Ninios, associate principal at consultants McKinsey & Co., says, "Whether a regulator should approve an LBO transaction really depends on the company he or she is dealing with.

An LBO is valuable only if the regulator and the company can negotiate an equitable distribution of value creation between customers and shareholders."

As far as the capital structure at the utility, Ninios says, "There is no magic debt/equity ratio for regulated businesses. What is appropriate is defined by the risk/return of the regulator and the shareholders. Assuming you know what this ratio is, you need to review the balance sheet and you also need to look at the contractual obligations of the regulated utility. You need to know how it buys and sells power and fuel. Furthermore, you need to evaluate its industrial customers, which could go bankrupt.

Regulators really need to understand commodity exposure because that drives how you want to structure your balance sheet."

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The KKR/UniSource Energy LBO: The Fine Points of the Deal

An anonymous Wall Street investment banker breaks down the important points of the deal for Fortnightly readers and analyzes how much KKR stands to gain. A source close to KKR confirms his analysis (see box).

1. On Nov. 23, 2003 UniSource announced that it had agreed to sell to an investor group (a partnership called Saguaro Acquisition Corp.) including KKR 62 percent, J.P. Morgan Partners 31 percent and Wachovia Capital

7 percent. The General partner is Sage Mountain LLC, owned by Frederick Rentschler, a long time KKR associate formerly associated with Armour-Dial, Beatrice and Northwest Airlines.

2. The transaction is priced at $25.25 per share, for a total equity value of $880 million and assumed debt of approximately $2.1 billion. Total enterprise value is approximately $3 billion. KKR's motivation for the deal was, among others: (i) the company was a small-cap utility with no research coverage and limited public market support; (ii) Arizona is a good load growth region; (iii) TEP has balanced, low-cost generation; (iv) there was significant noise around the Millennium investment; (v) the markets appear receptive to the transaction.
3. The sources of capital for the $880 million of equity will be $557 million of equity from the sponsors and the balance new notes ($300 million) and bank debt ($360 million). The balance of the debt will be used to fund a contribution of $260 million of equity capital to TEP, which will be used to repay an intercompany note and bring the equity ratio of TEP to 40 percent, which is the target set by the ACC. This is intended to attract support from the regulators. This also will result in incremental leverage at the holding company while de-leveraging the utility.
4. The transaction is subject to a number of closing conditions including, among others: (i) ACC approval (apparently the standard is no adverse impact to customers); (ii) no material adverse change, which includes a significant adverse rate case; and (iii) obtaining the incremental holding company financing. The rate case and ACC approval are expected to be taken together in June. There is a $25 million breakup fee.
5. The acquisition is at a trailing multiple of 8.6x EBITDA. However, the run rate multiple of EBITDA is closer to 6.5x, representing a run rate EBITDA of approximately $400 million to $425 million, versus LTM EBITDA of $313 million as of 9/30/03. The variance is largely a result of the synergies associated with Citizens acquisitions, which continue to come on line. The Springerville plant also represents $0.30 per share of upside, but it will not be on line until 2006. There are some cash and financial assets on the balance sheet which reduce the effective debt by $200 million to get to the 6.5x.
6. Holding Company Leverage - While there is an additional $660 million of holding company leverage, half of which is being contributed to TEP as equity and the other half used to acquire the public equity, the Partnership acquiring the entity is not expected to itself be leveraged. While this would increase the equity returns, there is a perception risk that would have a negative impact on the regulatory oversight/approval process, which will include both FERC and the ACC. Given KKR's commitment to the utility sector, they would have a lot to lose by hiding leverage on the structure.
7. There are several sources of upside that KKR will rely on: (i) additional leverage on the structure; (ii) the realization of cost savings initiatives from the Citizens deal; (iii) savings from the elimination of public company costs; (iv) synergistic add-on acquisitions; and (v) a very good load growth region in Arizona.
8. The existing $2 billion of debt - The debt is expected to be rolled. There is not a change of control at the utilities. Therefore, the utility debt (which is currently where the debt resides) is not implicated. Only this transaction is putting debt at the holding company.
9. Return analysis - The returns don't appear to be as poor as one might think. If the run rate EBITDA is really over $400, it appears that the cash on cash return to the equity, including the benefit of the holding company leverage, could be close to 20 percent without the benefit of any acquisition vehicle back leverage.

Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System[1]

INTRODUCTION AND BACKGROUND

On March 27, 2003, in Reno, Nevada, the Subcommittee on Accounting and Finance (Subcommittee) initiated a project to study "ring fencing" mechanisms and how such mechanisms can affect utility regulation. This paper represents an analysis of our findings.

Ring fencing has been defined in different ways but generally involves techniques used to insulate the credit risk of an issuer from the risks of affiliate issuers within a corporate structure.[2] Our interests in this project are directed toward identifying and analyzing the various ring fencing mechanisms that can be employed to insulate the regulated utility from the business practices and credit risks of sometimes highly speculative, non-regulated affiliates.

The Subcommittee has addressed the interrelationship of regulated utilities and non-regulated affiliates before. First, in 1999, the Subcommittee developed "Guidelines for Cost Allocations and Affiliate Transactions" (Guidelines) for energy utilities, which were adopted by NARUC at its Summer Meetings, San Francisco, California July 22, 1999. The adopted Guidelines are intended to "provide guidance to jurisdictional regulatory authorities in the

[1] Prepared by Timothy Devlin, Florida Public Service Commission, Rebecca Phillips, Kentucky Public Service Commission, and Thomas Ferris, Wisconsin Public Service Commission with the assistance of Chancy Bittner of the Iowa Utilities Board, David Hodgden and Joseph Buckley of the Ohio Public Utilities Commission, Charles Christiansen, California Public Utilities Commission, and Terri Carlock, Idaho Public Utilities Commission. This paper was prepared on behalf of the NARUC Staff Subcommittee on Accounting and Finance. Any views or opinion expressed by the authors are not necessarily those of NARUC, the Florida, Kentucky, and Wisconsin Public Service Commissions, or any other particular state utility regulatory commission.
[2] Bonelli, Sharon, Yee, Mona, CFA, and Lapson, Ellen, CFA (2003). Corporate Finance, Rating Linkage Within U.S. Utility Groups, Utilities, Holding Companies and Affiliates. Fitch Ratings: Global Power/North America Special Report, April 9.

development of procedures and the recording of transactions for services and products between a regulated entity and affiliates."[3] Essentially, these Guidelines address cross subsidization issues between affiliated companies.

Additionally, in 2000, the Subcommittee prepared a white paper, "Codes of Conduct Governing Competitive Market Developments in the Energy Industry: An Analysis of Regulatory Actions." The purpose of the White Paper was to study the various codes of conducts in place around the country and to analyze the application and effectiveness of the various components of such codes.

CURRENT FINANCIAL ENVIRONMENT

Due to recent events in the energy industry, including the implosion of Enron in late 2001, investigations into the trading activities of numerous marketers and the general glut of electricity in the marketplace, there has been a general trend towards electric utility bond downgrades. These downgrades have been most notable for electric utility companies operating within larger corporate structures and for those operating in states that have, or are in the midst of, restructuring. Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.

Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its

[3] NARUC Resolution Regarding Cost Allocation Guidelines for the Energy Industry, dated July 22, 1999.

parent's insolvency. As a consequence, ring fencing techniques are gaining the regulator's attention.

RING FENCING MECHANISM

There are several techniques that can be employed separately, or together, to insulate a utility from the risks of affiliate issuers within a holding company system. These include pro-active regulatory oversight, financial restrictions, structural separations, and operational controls.[4]

In ring-fencing, a shell is built around the utility by employing techniques to create a "package of enhancements." According to Standard and Poor's (S&P), a properly structured package of enhancements consists of three elements:[5]

1. A special "Structure," often including a "special purpose entity," structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent.
2. A tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the financial well-being and autonomy of the ring-fenced subsidiary.
3. The third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary.

According to Fitch,[6] "Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a

[4] Bonelli, Yee, & Lapson, page 4.
[5] Venkataraman, Swami, Standard and Poor's (2003). Holding Company Diversification and Its Impact on Regulated Operations. Speech before the NARUC Staff Subcommittee on Accounting and Finance, Reno, Nevada, March 26.
[6] Bonelli, Yee, & Lapson, page 2.

financially stressed parent has extracted dividends, inter-company loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company. Xcel and Allegheny Energy are two recent examples of holding companies that have refrained from transactions that impair the financial condition of their utility subsidiaries."

Structural separations are another way to insulate the utility from the risks of non-regulated affiliates. One such structural separation is multiple ownership. When a utility is controlled by at least two parents or is the subject of a joint venture, the financial problems of any one of the parents is less likely to have consequences for the credit quality of the utility. Generally, the utility will be better insulated if credible owners are on equal footing and are able to prevent each other from harming the credit quality of the utility.[7]

Holding Companies are generally structured in one of two ways. The first, more common structure, involves a nonregulated shell holding company, which owns the equity of both the regulated and nonregulated subsidiaries. In the second structure, the regulated utility operates as the parent holding company owning stock in various subsidiary companies.[8] It may prove to be easier to insulate a utility if it is held as a subsidiary in a holding company structure instead of a structure in which the utility holds the equity (and therefore the equity risk) of various subsidiaries.

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[7] Venkataraman.
[8] Bonelli, Yee, & Lapson, page 3.

In some instances, the utility is held as a division of a parent company, without a separate capital structure. In these instances, the regulator might want to consider requiring utility operations be held as a separate subsidiary instead of being operated as a division so that a clearly separate capital structure can be defined. As Fitch notes, the holding company structure aids in the construction of a strong ring fence. A regulated utility operating as a division of the parent company results in a higher risk profile for the utility than if held as a separate subsidiary. [9]

The final way to achieve insulation is the imposition of restrictions from the outside -- from regulation, or even legislation, particularly at the state level. The strongest form of regulatory insulation exist where there are tight, statute-based restrictions on cash and asset transfers coupled with active and pre-emptive oversight by the regulatory body. [10]

State Commissions generally have broad powers to protect utilities from any adverse actions of affiliated companies. Some of these powers are explicitly provided for by statute, including prohibitions on the use of debt for non-utility purposes and encumbering utility assets for non-utility purposes. The regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements as discussed above. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk of the utility being pulled into bankruptcy along with its parent or other affiliated company. This could also require a tightly drafted set of covenants subject to commission review.

[9] Bonelli, Yee, & Lapson, page 3..
[10] Venkataraman.

Additionally, many Commissions have codified Codes of Conduct and Cost Allocation Rules as the energy market has evolved toward a more competitive market. Other tools employed by Commissions to safeguard utility assets have been established through Orders under the Commissions' broad power of ensuring that utilities provide safe, adequate, and reliable services at just and reasonable rates (or prices).

S&P states that "insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation." S&P also states that, "Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."[11]

In a recent presentation to the Subcommittee, S&P named three states that they believe have adequate regulatory insulation mechanisms. Interestingly, one example involves a Commission Order, not a definitive statute. These states and mechanisms are:[12]

1. The Wisconsin Commission has explicit statutes governing the energy utility/affiliate relationship. Statute 196.795(5)(g) requires that "no holding company system may be operated in any way which materially impairs the credit...of any public utility affiliate." Statute 196.795(5)(c) and (d) prohibit a utility from lending money to or guaranteeing any obligations of its parent holding company or any nonutility affiliates. Statute 196.795(6m)-Asset Cap, limits nonutility investments to 25 percent of public utility assets with certain exceptions. Statute

[11] Ferara, William (2002). Research: Is State Utility Regulation Coming Back Into Vogue?. Standard & Poor's Ratings Direct, October 4.
[12] Venkataraman.

196.795(5) also includes provisions limiting subsidies between the utility and nonutility affiliates. Statute 196.52 relates to relations with affiliated interests and Commission control of affiliate contracts. Statute 196.80 requires Commission approval for an energy utility to merge, consolidate, acquire the stock of any other public utility, or sell, acquire, lease, or rent any public utility plant or property constituting an operating unit or system. Statute 196.795(3) regarding "takeovers" requires commission review and approval before allowing anyone to own more than 10 percent of the outstanding voting securities of the holding company.
Statute 201.03 requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Finally, Statute 196.795(4), for utilities in an energy holding company system, and 201.11 authorize the Commission to order a utility to cease paying dividends on its common stock when there is a finding of capital impairment.

2. The Oregon Commission placed certain conditions in its Order approving the Portland General Electric Company (PGE)/Enron merger. Most notable, "PGE must maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron." The 8-notches bond rating differential between PGE and Enron would seem to indicate successful ring fencing.

3. The Virginia Commission also has explicit statutes regarding utility/affiliate relationships. Chapter 3 (§56-58) of Title 56 of the Code of Virginia requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Additionally, Chapter 3 (§56-59) and Chapter 4 (§56-82) require that utilities, prior to assuming obligations as a guarantor, seek Commission approval for such guarantees. Chapter 4 (§56-82) requires utilities to gain Commission approval for affiliate loans. Chapter 4 (§56-83) authorizes the Commission, under certain circumstances, to prohibit a utility from paying dividends to an affiliate. Chapter 5 requires that prior to the change in ownership or control of : (1) a utility operating in Virginia, (2) any utility asset located in Virginia, or (3) utility securities occurs, Commission approval must be obtained. Under SEC Rule 53(c) of the Public Utility Holding Company Act, the Virginia Commission has been able to get utilities to agree that measures will be taken if bond ratings fall to certain levels. These conditions were based on the above mentioned statutes.

In summary, of the three states that S&P mentioned, two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

FEDERAL ROLE

As noted by Fitch, the Public Utilities Holding Company Act of 1935 (PUHCA) has some positive effect on the credit quality of subject utilities by regulating holding companies on matters including company structure, intercompany loans, reporting, acquisitions, and issuance and sale of securities.[13] Furthermore, according to the American Public Power Association (APPA), the financial problems of many electric utilities and utility holding companies today can be traced directly to the partial repeal and weakened safeguards of PUHCA via the enactment of the 1992 Energy Policy Act.[14] If PUHCA is totally repealed despite concerns (as is being seriously considered), it becomes increasingly important for the states to augment their own ability to monitor and regulate holding companies.[15] There is some concern that the Commerce Clause could severely constrain the ability of a state to regulate a multi-state holding company.[16] In any case, the importance of oversight will only increase if the repeal sets off, as some expect, another major merger wave.

[13] Bonelli, Yee, & Lapson, page 2.
[14] APPA, "The Public Utility Holding Company Act—Its Protections Are Needed Today More Than Ever," February 2003, p. 4.
[15] In this regard, also see the January 30, 2002, letter of John D. Dingell and Edward J Markey to Harvey L. Pitt, then Chairman of the SEC, at http://www.house.gov/commerce_democrats/press/107ltr129.htm.
[16] Anderson, John, "Commentary: Pro & Con," Public Utilities Fortnightly, July 15, 1995, p. 38.

The Federal Energy Regulatory Commission (FERC) has recently undertaken steps to increase its active oversight of utility/holding company relationships for those utilities under its jurisdiction. These steps include an on-going rulemaking initiative into cash management practices[17] and a recent decision to impose new conditions to all future public utility issuances of secured and unsecured debt authorized by the commission. These conditions are:[18]

1. Public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only.
2. If any utility assets that secure debt issuances are "spun off," the debt must follow the asset and also be "spun off."
3. If any of the proceeds from unsecured debt are used for nonutility purposes, the debt must follow the nonutility assets. If the nonutility assets are "spun off," then a proportionate share of the debt must follow the "spun-off" nonutility asset.
4. If utility assets financed by unsecured debt are "spun off" to another entity, then a proportionate share of the debt must also be "spun off."

There is also an amendment to the national Energy Bill that addresses corporate and financial separation. If passed into law, this would presumably increase FERC's authority and articulate a needed mandate to protect public utilities from the financial distress caused by risky investments made by utility parent companies in nonutility businesses. However, the proposed legislation does not provide states with the additional authority needed to better ensure that consumers are protected from potential abuses by large, unrestricted holding companies. Such additional authority would include the right of the states to form joint oversight bodies to conduct financial and managerial audits of multi-jurisdictional utilities, including those operating within a larger corporate structure. This authority would provide for such audits and other oversight actions as states deem necessary with or without federal agency involvement.

[17] FERC, "Regulation of Cash Management Practices," Docket No. RM02-14-000.
[18] FERC, "Commission Sets New Conditions for Utility Debt Acquisition," Docket No. ES02-51-000, News Release, February 20, 2003.

RING FENCING AND BANKRUPTCY

As previously mentioned, ring fencing aids in protecting the utility from the financial problems of non-regulated affiliates. The extreme case would be one of bankruptcy. In California, Edison International and Pacific Gas & Electric Corp. attempted to protect its subsidiaries from insolvency by implementing the following ring fencing measures:[19]

1. Making certain subsidiaries into special purpose entities (SPE) or "limited purpose operating entities" similar to an SPE;
2. Providing a nonconsolidation opinion between subsidiary and parent (upon insolvency of the parent, the assets of the subsidiary would not be consolidated with the parent's);
3. Securing legal comfort that the ring-fencing did not contradict any law, regulation, order, or contract; and
4. Securing other legal comfort that the ring-fencing would not invoke any of the "recharacterization" provisions of the Federal Bankruptcy Code.

Since a parent may have the incentive to file a subsidiary utility into bankruptcy, there are other economic measures that could be undertaken. These include termination provisions in certain contracts (i.e. commodity hedge) in the event of non investment grade rating.

On April 23, 2003, several state commission staff members and analysts at Fitch discussed ring-fencing. Fitch pointed out there is no perfect ring fence that can completely insulate a utility. They question certain techniques such as the "golden share" where an independent director for a utility has certain powers. More importantly, according to Fitch, companies have an inalienable right to file a subsidiary into bankruptcy. A company cannot waive this right according to the General Counsel at Fitch. Regardless, Fitch mentioned several measures that aid in the insulation of the utility and include: (1) minimum debt/cash flow ratio, (2) separate books and records, (3) separate subsidiaries, and (4) limitation on upstream loans.

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[19] Rigby, Peter (2001). Ring Fencing Subsidiaries From Parents' Bankruptcies in California. Standard & Poor's Project & Infrastructure Finance, October, 121-123.

The filing of a bankruptcy creates an automatic stay that halts all attempts by creditors to collect their claims from debtors. Creditors who willfully violate the automatic stay are subject to sanctions. However, federal, state and local government agencies are not subject to the automatic stay in the exercise of certain police or regulatory powers.[20] Regulatory actions of an economic nature would probably not be exempted from the automatic stay. Most state commission actions are of an economic nature and therefore, are mooted by bankruptcy filing.

POSSIBLE RING FENCING MEASURES

While according to the ratings agencies, state statutory authority is the preferable tool to properly insulate the regulated utility from non-regulated affiliate activities, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive from a credit rating standpoint. Only when sufficient regulatory insulations exist will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.[21]

To the extent permitted under its state statutes and depending on the specific circumstances, in any rate case proceeding, approval of mergers, approval of affiliated interest contracts, approval of securities, or any other similar proceedings, a state commission may want to consider ways to insulate a utility in a holding company system by restricting the flow of the utility's cash to its parent company, such as overhead

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[20] Overview of Bankruptcy and the Impact of Bankruptcy on the Regulatory Process, United States Trustee for Region 21, Northern District of Florida, Tallahassee, Florida.
[21] Ferara.

allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.[22]

The following are suggested areas to be considered ring fencing measures (some are more strenuous forms of others given):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any non utility business.

2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity ratio balance.

3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.

4. Commission authority over the establishment of a holding company structure involving a regulated utility.

5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

[22] Ferara.

CASE: UM 1250
WITNESS: Thomas D. Morgan

PUBLIC UTILITY COMMISSION OF OREGON

STAFF EXHIBIT 104

Exhibits in Support of Direct Testimony

CONFIDENTIAL VERSION
March 20, 2007

STAFF EXHIBIT 104

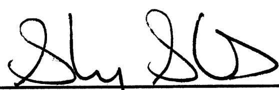
IS CONFIDENTIAL AND SUBJECT TO PROTECTIVE ORDER NO. 06-527. YOU MUST HAVE SIGNED APPENDIX B OF THE PROTECTIVE ORDER IN DOCKET UM 1250 TO RECEIVE THE CONFIDENTIAL VERSION OF THIS EXHIBIT.

CERTIFICATE OF SERVICE

UM 1250

I certify that I have this day served the foregoing document upon all parties of record in this proceeding by delivering a copy in person or by mailing a copy properly addressed with first class postage prepaid, or by electronic mail pursuant to OAR 860-13-0070, to the following parties or attorneys of parties.

Dated at Salem, Oregon, this 20th day of March, 2007.



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UM 1250
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